NOTE

This Microfiche meets the quality requirements of the American National Standard for Microfiche of Documents (ANSI PH5.9-1975). However, because of imperfections in the document from which it was made, it contains images that are illegible or difficult to read. The source document for this microfiche is the best copy that could be obtained prior to filming.

CIS

Congressional Information Service,
Washington, D.C

Union Calendar No. 30

101st Congress
1st Session
HOUSE OF REPRESENTATIVES
Report
101-48

THE 1989
JOINT ECONOMIC REPORT

REPORT

OF THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

ON THE

1989 ECONOMIC REPORT OF THE PRESIDENT

TOGETHER WITH

MAJORITY, MINORITY, AND ADDITIONAL VIEWS

May 9, 1989.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

---

U.S. GOVERNMENT PRINTING OFFICE
95-154 WASHINGTON : 1989

For sale by the Superintendent of Documents, U.S. Government Printing Office
Washington, DC 20402

J843-1

JOINT ECONOMIC COMMITTEE

(Created pursuant to Sec. 5(a) of Public Law 304, 79th Cong.)

LEE H. HAMILTON, Indiana, *Chairman*
PAUL S. SARBANES, Maryland, *Vice Chairman*

HOUSE OF REPRESENTATIVES	SENATE
AUGUSTUS F. HAWKINS, California	LLOYD BENTSEN, Texas
DAVID R. OBEY, Wisconsin	EDWARD M. KENNEDY, Massachusetts
JAMES H. SCHEUER, New York	JEFF BINGAMAN, New Mexico
FORTNEY PETE STARK, California	ALBERT GORE, Jr., Tennessee
STEPHEN J. SOLARZ, New York	RICHARD H. BRYAN, Nevada
CHALMERS P. WYLIE, Ohio	WILLIAM V. ROTH, Jr., Delaware
OLYMPIA J. SNOWE, Maine	STEVE SYMMS, Idaho
HAMILTON FISH, Jr., New York	PETE WILSON, California
FREDERICK S. UPTON, Michigan	CONNIE MACK, Florida

Joseph J. Minarik, *Executive Director*
Richard F Kaufman, *General Counsel*
Stephen Quick, *Chief Economist*
David R. Malpass, *Minority Staff Director*

LETTER OF TRANSMITTAL

May 9, 1989.

Hon. Jim Wright,
Speaker of the House, U.S. House of Representatives,
Washington, DC.

Dear Mr. Speaker: Pursuant to the requirements of the Employment Act of 1946, as amended, I hereby transmit the *Report of the Joint Economic Committee*. The analyses and conclusions of this *Report* are to assist the several Committees of the Congress and its Members as they deal with economic issues and legislation pertaining thereto.

Sincerely,

Lee H. Hamilton, *Chairman.*

CONTENTS

Page

I. Introduction 1
II. The State of the Economy 2
    Strengths 2
    Weaknesses 3
    Uncertainties 5
    Conclusion 10
III. Economic Policy, Growth, Inflation, and Stability 10
    Fiscal policy 10
        Federal debt 11
        Taxes 12
        Spending 13
    Monetary policy 13
    Trade and international financial policy 14
    Conclusion 14
IV. Challenges to Economic Policy 14
    Promoting economic growth 15
        Education 15
        Infrastructure 16
        Productivity and R&D 17
    Maintaining economic stability 19
        The S&L crisis 19
        International debt 19
    Achieving a better America 20
        Poverty 20
        Homelessness 21
        Health care and the challenge of an aging population 22
        The environment 23
    Conclusion 24
V. Future Directions 24
    The better America 24
    Maintaining economic stability 25
    Increasing economic growth 25
    Conclusion 27

MAJORITY VIEWS

I. Introduction 28
II. Current Fiscal and Monetary Policy 29
    Fiscal policy 29
    Budget priorities 33
    Monetary policy 34
    Conclusion 34
III. Near-Term Risks of Current Policy 34
    Inflation 34
    Structural risks to the economy: Financial fragility 36
    International economic imbalance 36
    Policy choices to reduce near-term risks 39
IV. Economic Policy for the Long Term 41
    The role of the budget 42
    Social Security and long-term growth 43
    The administration's budget policy 44
    Policy priorities for the long term 48
V. A Two-Tiered Economy 50
    Growing income inequality 51

Page
        - The policies of the 1980's — 51
        - Policy choices — 52
- VI. Conclusion: A Window of Opportunity — 54
- Additional Views:
    - Representative Augustus F. Hawkins — 56
    - Senator Paul S. Sarbanes — 57
    - Senator Lloyd M. Bentsen — 59
    - Senator Jeff Bingaman — 60

MINORITY VIEWS

- Preface — 61
- I. Economic Prospects — 64
    - Policies of prosperity — 65
        - Fiscal policy — 65
        - Monetary policy — 65
        - Regulatory policy — 65
        - International trade policy — 66
    - Forecast for 1989: The expansion continues — 66
    - The 1990's: Challenges of an open economy — 66
- II. Economic Growth and the Rising Standard of Living — 68
    - The rise of the middle class — 68
    - Good jobs at good wages — 70
- III. The Federal Budget — 71
    - Budget outlook — 73
    - The rise of faction and erosion of democratic institutions — 75
- IV. International Trade: Review and Prospects — 77
    - The dynamics of an open system — 78
        - The economics of enlarged markets — 78
        - The politics of enlarged markets — 78
    - U.S. and global trade developments — 79
    - The American challenge ahead — 80
        - The trade deficit and the U.S. economy — 81
        - The adjustment process — 82
    - The inherent strength of an openness strategy — 85
- V. Demographic Change and Its Economic Implications — 87
    - A demographic profile of the United States — 88
        - Trends in education — 90
        - Geographic trends — 90
        - A projection of regional change, 1986–2000 — 90
        - A changing Congress — 93
    - The economic implications of demographic change — 93
    - Change in the labor force — 94
    - Change in the workplace — 96
        - Industrial employment prospects — 96
        - Occupational employment prospects — 97
    - Public policy ramifications — 98
- VI. Conclusion — 99
- Additional Views:
    - Representative Olympia J. Snow — 100

Union Calendar No. 30

101st Congress
1st Session
HOUSE OF REPRESENTATIVES
Report
101-48

THE 1989 JOINT ECONOMIC REPORT ON THE 1989 ECONOMIC REPORT OF THE PRESIDENT

May 9, 1989.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

Mr. Hamilton, from the Joint Economic Committee,
submitted the following

REPORT

together with

MAJORITY, MINORITY, AND ADDITIONAL VIEWS

I. Introduction

With both a new President and a new Congress in place, the U.S. economy faces policymaking challenges. Many important economic indicators suggest no need to change the course taken since the early part of this decade. Yet other economic signposts suggest revisions in the map of U.S. economic policy to reflect the changing landscape and its own legend of potential hazards. What agenda, then, should guide the new policy team in Washington?

This Report assesses the state of the U.S. economy. It finds an economy with significant strengths and a reasonable prospect of continued expansion, along with weaknesses and uncertainties in the economic environment. This creates challenges for the future. The Report also finds that certain aspects of our economic performance and policy are aimed more toward near-term objectives than long-term strength. To orient our economic policy more toward the future, not surprisingly, we must forgo some gratification in the present. The choices to be made sometimes divide the Members of this Committee; but the importance of meeting these challenges is beyond debate.

II. THE STATE OF THE ECONOMY

The combination of U.S. economic indicators today is unprecedented. It suggests the economy has important strengths and weaknesses as well as several areas of uncertainty.

STRENGTHS

The American economy in 1989 shows considerable vitality. The recovery that began in 1982 has achieved a record duration of more than 25 quarters. Real gross national product (GNP) growth was 3.4 percent in 1987 and 3.9 percent in 1988.

Employment growth has also been strong, with averages of 286,000 per month in 1987 and 303,000 new jobs per month in 1988. While job creation earlier in the recovery was concentrated almost entirely in the service sector, recent employment expansion has been more evenly balanced, with manufacturing adding over 392,000 jobs during 1988. This strong employment growth drove the unemployment rate down to 5.0 percent in March, the lowest level in over 15 years.

Inflation remains much improved over the mid- and late-1970's, though few would argue that it is low enough. Inflation as measured by the Consumer Price Index (CPI) has remained essentially stable since 1983, even though employment growth and capacity utilization might have suggested that it would accelerate. Current unemployment rates are within the zone where many economists start to worry about accelerating inflation, based on the experience and the labor force composition of the 1970's. So far, there is no significant evidence of upward pressure on wages in excess of productivity gains, or of rising labor costs being passed through in higher prices. Likewise, inflation has not responded to manufacturing capacity utilization of 84 percent, a level which has often created capacity constraints, a short supply of goods, and rising prices. These developments suggest that the effect of unemployment and capacity utilization on inflation might be changing in a favorable way.

Different sectors of the economy have taken the lead as sources of growth since the recovery began. In the initial months, growth was driven by an increase in consumer demand and residential investment, followed by an increase in nonresidential investment. After 1985, when the dollar's value began to decline in international markets and foreign growth rates increased, exports accelerated to pace the economy. Manufacturing firms especially took advantage of the swing in exchange rates, and moved quickly to expand U.S. production facilities to meet export demand.

This shift in the composition of demand toward exports has been a positive development for the economy, as it has facilitated a strong rebound in the manufacturing sector. After several weak years in the early part of this decade, industrial production rose significantly faster than overall GNP during both 1987 and 1988. The robust productivity growth in manufacturing has helped to pull up the growth rate of productivity in the economy as a whole.

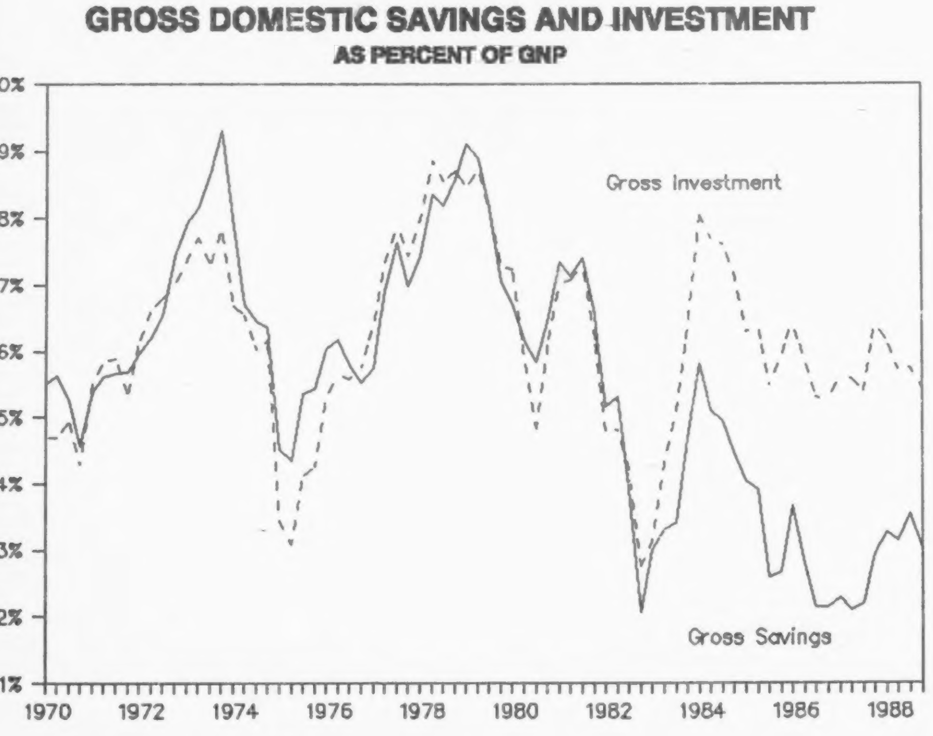
The economy has also demonstrated substantial resilience in the face of external shocks. Industries based on natural resources were hard hit during the early 1980's, when high interest rates and slow economic growth around the world depressed commodity prices. Yet these same industries were able to expand production quickly to meet the post-1985 export boom without supply bottlenecks or significant acceleration of inflation.

WEAKNESSES

There are two primary weaknesses in the current macroeconomic environment. First and foremost is the persistent shortfall of savings relative to investment in the American economy. The Nation simply consumes so much of its output that there is not enough left over, or saved, to meet its investment needs. The Nation has met this savings shortfall by borrowing overseas to finance its investment.

As Figure 1 shows, gross domestic investment (the sum of all business purchases of buildings, machines, and inventories in the United States) fell during the recession of the early 1980's, but rose strongly with the recovery. However, gross domestic savings (the sum of savings by households and businesses less the net deficit of all levels of government) did not match investment growth, and, in fact, declined and has remained at a relatively low level throughout the recovery.

FIGURE 1

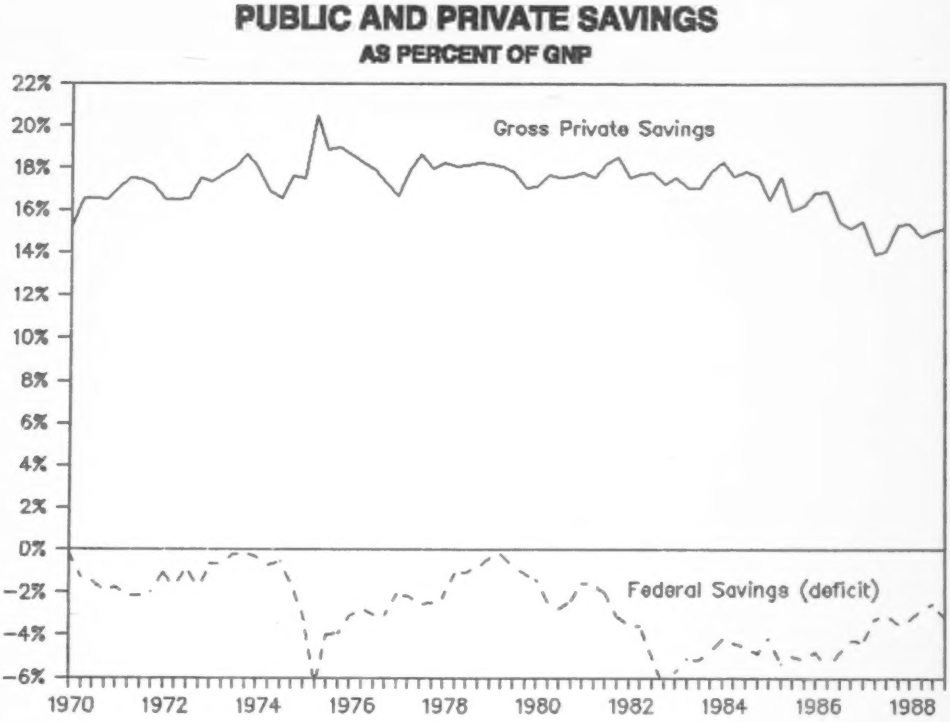

GROSS DOMESTIC SAVINGS AND INVESTMENT
AS PERCENT OF GNP

Source: National Income Accounts

A major contributor to the erosion of domestic savings has been the Federal budget deficit, which rose from 2.8 percent of GNP in

Fiscal Year 1980 (FY80) to 5.0 percent of GNP in FY84. The Federal budget deficit has declined as a percent of GNP since 1985, falling to an estimated 3.4 percent during FY89, still very high for an economy well into an expansionary period. But as Figure 2 indicates, private savings declined by 2.5 percent of GNP over the same period, more than absorbing the improvement in the Federal budget deficit and leaving the economy with a continuing imbalance between savings and investment.

FIGURE 2



Source: National Income Accounts

By widening the imbalance between savings and investment, the deficit has created a series of problems for the American economy. For instance, the additional demand for credit to finance U.S. investment over and above what the Nation is willing to save holds real interest rates higher than they would otherwise be. This pressure crimps the growth of interest-sensitive sectors of the economy. It is of particular concern in the area of business investment, where the 1989 Annual Report of the Council of Economic Advisors (CEA) noted:

> Although there are disputes about estimated effects, studies indicate that the overall effects of deficits in the postwar era has been to reduce U.S. capital formation.

The large Federal budget deficit also shifts the burden of current expenditures from current taxpayers onto succeeding generations.

The second area of weakness in the American economy concerns the vulnerability of many financial institutions. The high interest rates during the late 1970's and early 1980's put an enormous strain on those financial institutions, especially savings and loan associations (S&L's), which had to compete for short-term funds at high interest rates, while their preexisting long-term assets (such as home mortgage loans) earned substantially lower rates of interest. Many S&L's have failed in recent years, and many more have survived only by venturing into investments with higher yields but significantly greater risks. Some banks hold large volumes of high-risk loans to developing nations. The shakiness of those loans and of many S&L's is a danger to the economic expansion.

UNCERTAINTIES

Several features of today's economy are unprecedented, and a number of longstanding "rules of thumb" in policymaking seem irrelevant given today's changing economic relationships. For example, after the stock market crash of 1987, economists anticipated either a slowdown or a recession. Instead, the economy has grown strongly. This experience has reemphasized how much we do not know about the workings of the economy. Thus, there are several aspects of the economy that bear watching.

One realm of uncertainty now is the near-term course of inflation and growth. With unemployment relatively low and capacity utilization relatively tight, a primary concern in financial markets is a potential resumption of inflation. Two international factors helped to restrain inflation in the 1980's—falling oil prices and the willingness of foreign producers to hold their U.S. prices stable even at the expense of profits when the dollar fell. These influences may not continue to be favorable; oil prices rose this winter, and the dollar has been relatively stable. January's and February's increases in Producer Price Index (PPI) (the largest in three years) and in the CPI lend added substance to these concerns.

While inflation is seen by some as the key threat to the recovery, others fear a more immediate recession. Short-term interest rates have recently risen above long-term rates (a development called an inversion in the yield curve) for the first time since the recession at the start of this decade. In the past, yield-curve inversions have often signaled either slowdowns or recessions, which suggests that caution is appropriate.

The composition of growth in recent months causes concern about both recession and inflation. The Nation needs growth in exports and investment: exports to help close the trade gap, and investment to lay the foundations for future growth. And through the middle of 1988, the economy produced exactly this pattern of growth. During 1987, real GNP rose 3.4 percent, but real gross private domestic investment increased 4.9 percent and real exports rose 13.1 percent. Real personal consumption expenditures, however, rose only 2.7 percent, indicating a clear shift toward investment and exports and away from consumer demand.

This picture may have changed in the second half of 1988. In each quarter of 1988, real consumption grew faster then real GNP, with the gap widening in the third and fourth quarters. Real investment increased more slowly than GNP. Real exports grew faster than GNP in each quarter, but slowed somewhat toward the end of the year; real imports, on the other hand, increased strongly in the third and fourth quarters, producing small increases in the real trade deficit for both quarters.

This possible shift in the composition of output suggests an uncertainty in today's economy. If exports and investment resume their leading role, then balanced growth can proceed. On the other hand, if exports and investment weaken and government spending grows moderately, consumer demand will be left as the engine of growth. If that demand materializes, it could jeopardize progress on reducing the trade deficit by increasing imports. The increased demand could put upward pressure on domestic prices. The resulting downward pressure on the dollar could also add to inflation. But if consumer demand does not strengthen, then the economy could slide toward recession directly. Further deterioration of export and investment performance would seriously threaten the expansion.

The large U.S. trade deficit is a second uncertainty in the economic outlook, particularly the path of exports. The interpretation of our trade deficit is controversial. Some economists argue that foreign investors saw opportunities in the United States during the early 1980's, and so chose to invest here. Because they had to purchase dollars to do so, they drove the value of the dollar upward, which made imports cheaper in the United States and our exports more expensive overseas. To these economists, the fall in the dollar since 1986 has reversed a part of the problem, and the decline of the trade deficit since early 1988 is seen as support for this view.

An alternative explanation of the trade deficit is less encouraging. During the 1980's according to this explanation, households, businesses, and governments consumed and invested more than they produced; the excess of spending over production had to be imported; and the money to pay for those net imports had to be borrowed from foreign investors. As a result, foreign claims on future U.S. output grew far faster than U.S. investments abroad.

While there is dispute as to whether foreign purchases of U.S. assets have gone so far as to make us a net debtor nation, it is certainly true that the United States has sold substantial amounts of assets to foreigners, and has thereby forsworn future claim to the interest and dividend income that those assets will generate.

Foreign borrowing will be needed until the United States starts running a trade surplus large enough to meet our interest and dividend obligations to foreigners on their accumulating assets in the United States. Thus, our foreign borrowing to date has allowed us to consume more than we produced, and to maintain higher investments levels than our low savings rate would otherwise permit.

Our shortfall of savings relative to investment and the consequent inflows of foreign capital complicate the making of U.S. monetary policy. Monetary policy must keep the dollar attractive to foreign investors, because investments in dollar-denominated assets by foreigners rise and fall with the dollar in the value of their own currencies. In the past, this concern has kept interest rates higher than those overseas, hurting interest-sensitive sectors of the United States.

The events of October 1987 demonstrate a further concern that international capital markets can transmit financial shocks among nations with remarkable speed. Thus, even though the United States can probably borrow whatever it needs, the potential for short-term interruptions of financial flows strong enough to slow the economy cannot be ignored.

A third area worth watching is the pace of productivity improvement in the American economy. Economists agree that, over the long run, a nation's standard of living grows as fast as it can increase the value of goods and services produced by an hour's worth of human labor. In the early postwar years, productivity in the American economy was strong, averaging 3.3 percent per year between 1948 and 1966 and 2.1 percent per year between 1966 and 1973. Productivity growth stalled in the 1970's, and has recovered partially to an average rate of 1.7 percent per year in the 1980's. Much of this growth is concentrated in manufacturing, with productivity growth in the rest of the economy much slower.

The reasons for the productivity slowdown that began in the early 1970's are unclear despite numerous studies by academic researchers and official institutions. Some part of the slowdown may be attributable to difficulties in measuring "output" in service industries, and some may be due to the process of absorbing the extremely large "baby-boom" generation into the labor force (with its less experienced and presumably less productive workers).

These explanations leave the productivity outlook uncertain. Some economists might argue that the productivity rebound thus far in the 1980's was largely temporary. Productivity always increases most rapidly in the early years of an economic recovery, as businesses expand their operations; but productivity growth slackens off as the economy approaches full employment and businesses stabilize their operations. That has been the pattern of the 1980's; rapid productivity growth early in the recovery has slowed to 1 percent or less in the last two years. The arguments might continue that demographic explanations of slower productivity are not persuasive, because the baby-boom generation has now largely entered the workforce and moved toward its prime working years with little noticeable improvement in overall labor productivity. Finally, shifts to service production do not explain our slower productivity growth relative to other nations, because other countries with well-developed service sectors have shown more robust productivity growth than we have. The conclusion would be that productivity is likely to continue to grow only modestly.

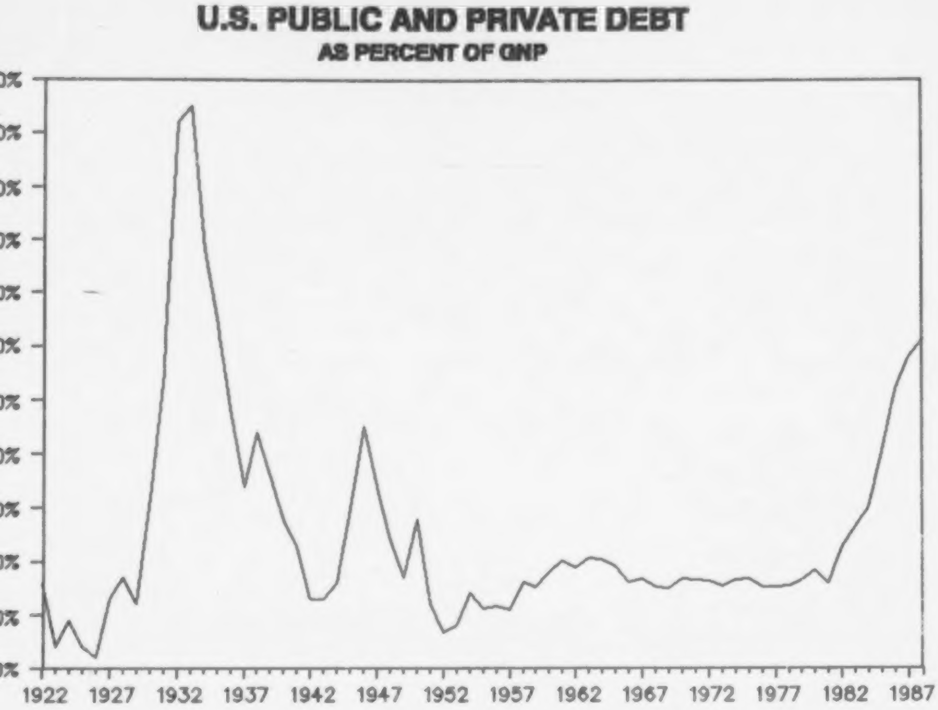
A more optimistic view, beyond citing the measurement problems in service output, would emphasize the demographic factors. By this view, the United States has laid the ground work for future productivity growth by employing the large number of new workers who have pulled down the productivity statistics in the 1970's and the 1980's. With its added experience, the baby-boom generation will be more productive in the years to come. Because the children born in 1946 are now reaching age 43, this argument goes, they will continue to increase their skills and experience for at least another decade, and so the economic payoff of the maturing of the baby boom is not yet in hand.

Though our knowledge of the causes of productivity growth is quite limited, the impact of small changes in productivity, compounded over several decades, can be enormous. If the maturing of the baby boom will yield further productivity gains, it will have a considerable effect on U.S. living standards in the next century. Even in the short run, variations in productivity growth can have an important effect on the proper macroeconomic policy; monetary and fiscal policies should be different if we expect 1 percent productivity growth rather than 3 percent. And the slowdown in wage and family income growth since the early 1970's can be directly tied to our slower growth in productivity dating from that time.

A fourth area of uncertainty is related to the rise of debt in all sectors of the American economy. While debt levels are not high by international standards, they are high by U.S. standards and must be viewed with caution. Figure 3 demonstrates that the ratio of debt outstanding to GNP has risen sharply during the 1980's—first driven by public debt but later by household and corporate debt as well. Increased leverage in the household sector raises questions about the response of consumer demand to higher interest rates and the threat of corporate bankruptcies triggered by recession. In the corporate sector, the recent wave of takeovers, leveraged buyouts, and stock buy-backs has significantly increased the debt ratios of certain U.S. firms. Although there is disagreement about whether increased leverage is good for the individual firm, Professors Franco Modigliani and James Poterba have argued:

> There is general agreement that a larger number of highly leveraged firms means an economy less resilient to shocks like business contractions or sharp credit tightening.

FIGURE 3



Source: Federal Reserve and National Income Accounts

A fifth uncertainty concerns the large external imbalances in the world economy. During the 1980's, substantial concern has been voiced by both academics and public officials about the challenge which large imbalances (some nations with large trade deficits and others with large surpluses, rather than all nations close to balance) pose to the stability of the international financial and trading systems. Commentators have uniformly welcomed the reduction in these imbalances that has occurred since 1987, when both the U.S. trade deficit and the surpluses of Japan and Germany began to decline. But approximately midway through 1988, this adjustment process began to slow down. The Japanese and and German surpluses started growing again in the third and fourth quarters of 1988, and improvement in the U.S. trade deficit slowed down dramatically.

This new development could represent either a "pause" in the adjustment process or a more fundamental cessation of progress. If the adjustment process has indeed stopped, it could threaten the stability of the international currency system and could complicate negotiations for freer international trade.

The international debt situation is a sixth area of uncertainty. While financial institutions in the industrialized world have reduced their vulnerability to default by heavily indebted countries, the countries themselves have not achieved strong economic systems or adequate rates of economic growth. Today's rising world interest rates strain the debtor countries just as many of them are making changes of government. Popular discontent, arising out of years of slow growth, poses a potent challenge to the stability of emerging democratic governments, and raises serious questions about present approaches to economic reforms and the international management of the debt problem.

CONCLUSION

The American economy enters its seventh year of recovery with significant strengths and a reasonable prospect of continued expansion. These strengths, along with weaknesses and uncertainties in the economic environment, create a set of challenges for the future; moving toward full employment and maintaining price stability; sustaining business capital investment and the recovery in net exports; managing difficult problems with both domestic and international debt; maintaining an adequate inflow of foreign capital at reasonable interest rates; and increasing growth of both productivity and incomes.

III. ECONOMIC POLICY, GROWTH, INFLATION, AND STABILITY

Unlike parliamentary systems, particularly those without an independent central bank, the American system of government disperses authority over economic policies. By law, the Administration and Congress share responsibility for fiscal policy, and the Federal Reserve exercises control over monetary policy. In practice, this division of authority has been blurred in the recent period of large budget deficits and concern about exchange rates. Now that annual interest payments have risen to almost 15 percent of the Federal budget, the Fed's influence on interest rates more directly affects the level of budget outlays and fiscal policymaking. On the other hand, the Fed's influence over the credit markets has been complicated by the increase in Federal Government borrowing required by budget deficits and off-budget credit activity. The Fed's autonomy is further limited by the growing emphasis placed on exchange rate policy by the Treasury.

To the extent that the goals and priorities of the Administration, Congress, and Federal Reserve diverge, the major fiscal and monetary policy decisions are not necessarily consistent. The sequence of the decisions and conflicts in recent years—and their consequences—is worth examining.

FISCAL POLICY

The size of the budget deficit was set to some extent by default in the early 1980's, as the Administration and Congress adopted differing priorities. The Administration won Congress' approval for a major shift in fiscal policy in 1981, when personal and corporate income tax rates were reduced sharply and increases in defense spending were accelerated. The Congress cut some domestic programs and reduced the rate of growth of others, but this was insufficient to prevent a widening fiscal deficit. Over the next two years, a deep recession and rapid deceleration of inflation helped to increase the deficit from $79 billion in FY81 to $208 billion in FY83.

Each year the Administration and the Congress differed on priorities, changing the mix of defense spending, domestic spending, and taxes, but making little change in the gap between spending and revenues.

The deficit remained around $200 billion for the next three fiscal years, and reached a record $221 billion in FY86. Expressed as a percentage of GNP, however, the deficit declined from 6.3 percent in FY83 to 5.3 percent in FY86. The Administration projects that the deficit for FY89 will be $170 billion—3.4 percent of GNP. While this figure represents an improvement over a few years ago, it remains high by historical standards for a peacetime economy in expansion.

The deficit improved significantly in FY87 and FY88, but likely will not in FY89. To assess the improvement, the official deficit measure must be adjusted for one-time accounting changes and asset sales, which do not represent changes in policy or a sustained improvement in the gap between expenditures and revenues. In addition, the 1986 tax law shifted the timing of revenue, although it was projected to be roughly revenue-neutral over the first five years. The Congressional Budget Office (CBO) has estimated the level of the deficit, absent these temporary effects, as $223 billion in FY86, $185 billion in FY87, and $146 billion in FY88. For FY89, the Office of Management and Budget (OMB) and CBO have slightly different projections of the official deficit and impact of the 1986 tax law, but both indicate little or no further improvement.

The accumulation of a socal security reserve against future obligations accounts for much of the improvement in the budget deficit since 1986. The annual social security surplus was $17 billion in FY86, and is projected to reach $54 billion in FY89. With the adjustments just described, the $37 billion increase is roughly half of the approximate $75 billion reduction in the unified budget deficit.

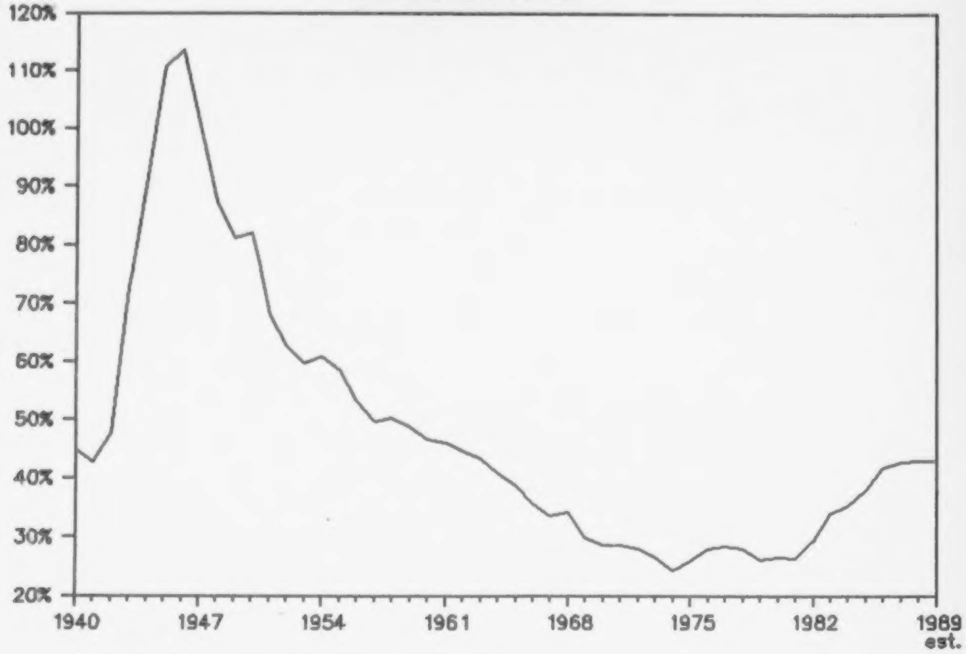
The budget deficit has been affected over the last three years by a number of factors other than budget policy. The deficit has been narrowed by continued strong growth in the economy, reductions in the rates of unemployment and poverty, and a decline in interest rates. On the other hand, the deficit has been widened by a mounting stock of debt to service, an increase in the elderly population, and rising costs of health care.

Federal debt

The Federal debt held by the public is projected to reach $2.2 trillion by the end of FY89. As recently as FY81, the debt was $785 billion. As Figure 4 shows, the ratio of Federal debt to GNP has climbed from a postwar low of 24.3 percent in FY74 to 42.9 percent in the last two fiscal years.

FIGURE 4

FEDERAL DEBT HELD BY PUBLIC
AS PERCENT OF GNP



Source: Office of Management and Budget

Taxes

There were major changes in tax policy thus far in this decade. Though difficult to measure in dollars, the extent of these changes was considerable. While total receipts increased from $599 billion in FY81 to a projected $976 billion in FY89, OMB has estimated that FY89 Federal revenues would have been a net $171 billion higher had the 18 pieces of tax legislation enacted since 1981 not become law. This estimate assumes that the economy would have performed no differently without these changes in the law. At issues among the Members of this Committee is whether the changes enabled the economy to perform significantly better than it could have otherwise.

The importance of various sources of revenues has shifted since 1981. The share of Federal revenues supplied by individual income taxes has declined from 48 percent in FY81 to 44 percent in FY89, and marginal tax rates on income have been substantially reduced. At the same time, social security and other social insurance revenues have risen from 31 percent to 37 percent of total revenues, corporate revenues have edged up from 10 percent to 11 percent, and excise taxes have declined from 7 percent to 4 percent.

Total government receipts were roughly the same percentage of GNP in FY88 as they were in FY81. While Federal Government receipts declined from 20.1 percent of GNP in FY81 (a post-World

War II high) to 19.0 percent in FY88, State and local tax receipts rose from 9.4 percent to 10.3 percent.

Spending

Although Federal Government outlays increased from $678 billion in FY81 to $1.064 trillion in FY88, they declined from 22.7 percent of GNP to 22.3 percent over that period. The composition of that spending has changed markedly. As a percentage of total outlays, net interest expense has risen from 10.1 percent to 14.3 percent, defense spending has climbed from 23.2 percent to 27.3 percent, social security payments have been a virtually stable share at 20.3 percent and 20.4 percent (in contrast to social security's markedly increasing role in revenues—the difference being an artifact of the growing social security surplus), and other entitlements have declined slightly from 27.0 percent to 26.7 percent. The share of the budget going to all other outlays—largely domestic discretionary spending—has declined from 30.9 percent to 21.7 percent of outlays

MONETARY POLICY

Officials of the Federal Reserve have often expressed the view that monetary policy must offset the inflationary threat posed by the large budget deficits of recent years. For example, in his testimony to Congress on monetary policy in July 1988, Chairman Alan Greenspan stated:

> Fiscal restraint in the years ahead would assist in making room for * * * net exports * * * to expand further without resulting in an inflationary overheating of the economy. Absent this fiscal restraint, higher interest rates would become the only channel for damping domestic demands if they were becoming excessive.

Few analysts would doubt that monetary policy was tight in 1981 and early 1982. However, monetary policy since 1982 has appeared tight by some measures and loss by others. Some gauge monetary tightness by the level of real interest rates (again measured by the difference between nominal interest rates and the rate of inflation). By that measure, monetary policy has been tight. Real interest rates of 4 to 6 percent have prevailed throughout the 1980's, in contrast with the historical average of 1 to 2 percent. Others contend that monetary policy has been moderate since mid-1982. As evidence, they point to the steady improvement in the rates of unemployment and industrial capacity utilization toward the cyclical peaks of the 1970's.

Other economists measure monetary tightness by the rate of growth of money or credit, defined in various ways. By the broadest definitions, both money and credit have grown relatively rapidly in some recent years. To these analysts, monetary policy has been too lenient for substantial periods. However, some of the "lenience" detected in the broadest measures of money and credit has occurred less by the design of the monetary authorities than through the major institutional changes and innovations for both borrowers and savers. Households and businesses once considered uncreditworthy have been given new access to credit. Such borrowers have been willing to pay higher real interest rates than had prevailed in the past. This new market for credit has put additional demand pressures on the capital markets over and above the pressures imposed by government borrowing. Meanwhile, new financial intermediaries have emerged to pay higher interest rates to savers and to pass on the funds to the borrowers previously deemed too risky for credit. This expansion of private credit has also contributed to the substantial reduction in private savings described earlier.

TRADE AND INTERNATIONAL FINANCIAL POLICY

In the 1980's, as was discussed earlier, foreign funds filled the gap between savings and investment to keep gross domestic investment near the postwar average level. As the dollar and the trade deficit rose, more new restrictions were placed on imports into the United States than at any time since the 1930's. After negotiations with the U.S. Government, foreign producers agreed to new controls on their shipments of autos, steel, semiconductors, machine tools, textiles, and apparel to the United States.

The year 1985 marked a turning point for Federal Government policy on the dollar. From 1981 to 1985, the Administration had a policy of nonintervention in the currency markets. In February 1985, the dollar began falling, and in late 1985, the Administration began to coordinate efforts with other major industrial nations to encourage further depreciation of the dollar. By 1987, the dollar had returned almost to the level of 1980, and international coordination efforts shifted toward stabilizing currency levels.

After 1985, in part because of the decline in the value of the dollar, there was significant progress in narrowing the trade deficit. Reductions in the trade deficit and the savings-investment gap now appear to have slowed down. After more than two years of relative dollar stability, exports were still expanding in late 1988, but imports were rising just as much in dollar terms.

CONCLUSION

Relationships among economic variables are changing and increasingly complex. The Federal budget is still far from being balanced, with limited progress in the last year. Monetary policy, while demonstrably successful in contributing to our recent progress against inflation and unemployment, remains subject to conflicting characterizations as to its degree of restrictiveness—in part due to still-unfolding innovations in the financial markets. Further, the welcome movement toward full employment raises new challenges for the monetary authorities. Expansion in trade and capital flows have rendered the U.S. economy far more subject to international influences, and necessitated changes in policy that have continuing effects. Thus, current policies have their own dynamics and uncertainties that compound the challenges of the coming years.

IV. CHALLENGES TO ECONOMIC POLICY

During the 1980's, the United States reduced inflation significantly, pushed unemployment to a 15-year low, and achieved a record-length economic expansion. There are additional challenges that must be addressed today and into the 1990's to lay the groundwork for a better America. Among the highest priorities are investing in the future through quality education and training, research and development (R&D), and infrastructure needed to fuel future economic growth; ensuring the soundness of our financial system by resolving the Third World debt problem and the savings and loan industry crisis; and attacking poverty, achieving adequate housing and medical care, and leaving our children and future generations a clean and safe environment.

The Republican and Democratic Members of the Joint Economic Committee fully agree that our Nation's goal should be a future of continued economic growth and stability combined with opportunity and fairness. The urgency of this agenda transcends our partisan differences and demands an openness to fresh approaches and a willingness to negotiate. And many Americans would recognize the priorities discussed below.

We recognize the necessity of reducing large budget deficits, and so we must make choices. These choices often divide the Members of this Committee. Among the most fundamental issues are the merit of new proposals and existing Federal programs in these priority areas, and the appropriate roles of Federal, State and local governments, and the private sector.

PROMOTING ECONOMIC GROWTH

Education

Education is perhaps the most prominent area where our Nation's shortcomings threaten to impose enormous long-term costs; yet success in education is crucial to economic growth and the attainment of the social values that we all share. The United States spends more per student than other industrialized nations, but is still falling behind the rest of the industrialized world in promoting literacy, job skills, and educational achievement at every level. The combined elementary and secondary school student dropout rate is 25 percent—40 percent for blacks and over 50 percent for Hispanics. Approximately 13 percent of 17-year-old Americans cannot read, write, or count. It is estimated that an additional 17 to 21 million adults cannot read, and millions of others have skills so rudimentary that their productivity in the workplace is limited.

Early childhood education—such as the Head Start program—is widely agreed to be cost-effective in reducing the dropout rate and in increasing minority and disadvantaged academic performance and enrollment in university studies. Head Start returns to society an estimated $4.75 or more in benefits for each dollar spent, but only one in five eligible children is currently enrolled in the program. Providing Head Start to all eligible children would cost an estimated $2 billion per year.

Public education at the elementary and secondary levels (as well as postsecondary education) is largely the responsibility of State and local governments. In recent years, many States have undertaken vigorous initiatives to reform and adequately fund their educational systems. A Federal role in monitoring, encouraging, and rewarding this process has been recognized by such diverse organizations as the Committee for Economic Development, the National

Governors' Association, and the Council on Competitiveness, and has been expanded with overwhelming bipartisan support in the School Improvement Act of 1987 (the Hawkins-Stafford Act). New directions might include extending both school hours and the academic year. Additionally, to promote better job skills, the Nation needs vocational education programs that respond to the current needs of business and prepare students for the rapid and profound changes occurring in the contemporary workplace.

Higher education has become increasingly important to our economic performance. It is estimated that a majority of all new jobs created between now and the year 2000 will require postsecondary education, but there are serious problems of access and equity. Median family income increased by 6.4 percent (in constant dollars) over the 1980's, but public four-year college costs rose by 32 percent and private four-year college costs increased by 51 percent. The composition of student aid has also changed dramatically in the past decade. In 1987-88, loans accounted for 50 percent of student aid, up from 41 percent in 1980-81 and 17 percent in 1975-76, and the purchasing power of the Pell Grant has declined from about 45 percent of tuition in 1975 to 35 percent in 1986 at public institutions and from 20 percent to 14 percent at private institutions.

The increased costs and the decline in the availability of student aid grants, and the resulting increased reliance on loans, may have contributed to the reduction of college enrollment, especially of minorities. Enrollment of Hispanic high school graduates in college declined from approximately 36 percent in 1976 to 29 percent in 1986; black enrollment declined from 33.5 percent to 28.5 percent over the same period.

Improvements in educational performance do not come without short-term costs. For example, even if we could prevent all elementary and secondary school students from dropping out without expending resources, additional funds would then be needed to teach the 25 percent more students completing high school; and teachers' salaries in math, science, and other critical areas are not competitive with other opportunities in many parts of the Nation. Still, increased public outlays for education should be viewed as a necessary and vital investment to raise the quality of life for all Americans and to improve and maintain our Nation's productivity and its international economic position in the long run. There is a need to define properly the roles of different levels of government in providing the needed resources; the primary role of the State and local governments should be maintained, with an awareness that State and local tax burdens are reaching record levels, and that the cost of quality education is particularly burdensome in poorer localities.

Infrastructure

Roads, ports, water and waste-water systems, streets, and airports—our Nation's infrastructure—are another prerequisite for the Nation's economic and military security and its public health and safety. New investments by the private sector and at all levels of government should continually be made to keep pace with changing technology and the growth of industry and commerce. In addition, the nearly $3 trillion of existing infrastructure in the

United States must be maintained and upgraded to remain safe and useful.

In constant 1982 dollars, Federal spending for nondefense infrastructure is expected to increase to $15 billion in 1990, up from $9.1 billion in 1980. As a share of GNP, however, annual Federal spending for capital investments (direct nondefense expenditures and grants) has declined from 1.1 percent in the 1960's to 0.9 percent since 1980.

Federal grants to State and local governments for capital investments are estimated to decline in real terms by 2 percent per year between 1980 and 1990. The real decline in these grants, which generate vital investments in highways, sewage treatment plants, airports, and mass transit, poses a challenge to the maintenance of sound infrastructure and to government budget priorities.

In recent years, infrastructure capital investment from all sources has barely offset annual depreciation, and is not enough to meet new demands on the system. The Department of Commerce estimates that infrastructure use by industry alone will increase by at least 30 percent over the next 10 years. It is generally accepted that public sector investment in infrastructure contributes to productivity in the private sector, thus helping our industries to compete in world markets. The CEA's 1989 Annual Report recommended that consideration be given to expanding Federal infrastructure investment to improve future productivity.

The National Council on Public Works Improvement, created by Congress in 1984 to assess the state of America's infrastructure, concluded in its final report last year that there is "convincing evidence that the quality of America's infrastructure is barely adequate to fulfill current requirements, and insufficient to meet the demand of future economic growth and development." It recommended doubling the Nation's annual capital investment in public works through all levels of government and the private sector. The Federal Government's share would be about $15 billion in 1990. Partial funding is available from the transportation trust funds, which currently record a combined surplus of $26 billion. These funds could be judiciously drawn down for the purposes for which they were intended. Of course, like all spending, this will add to the budget deficit unless compensating changes are made elsewhere in the budget.

Noncapital approaches to infrastructure improvement include using facilities more efficiently; performing necessary maintenance in a more timely fashion; increasing reliance on user fees where appropriate; defining the responsibilities of the various levels of government and the private sector more clearly; and encouraging innovations in public works design, equipment, and construction.

Productivity and R&D

Productivity plays a major part in determining the Nation's economic growth and therefore our standard of living. The United States has experienced substantial growth in productivity in the post-World War II period, but less than Europe, Canada, and Japan. To some degree, other nations have made quick "catch-up" productivity gains just by copying U.S. technology, but this Nation's lead has been eroding faster than catch-up gains by others can explain.

Productivity growth rates have been slowed in all industrialized countries by the shift of economic resources from manufacturing to the delivery of services, which has slower productivity growth. However, U.S. service productivity has grown more slowly than in other nations, though it is particularly difficult to measure service output and productivity. The U.S. manufacturing sector has been much more successful in increasing productivity; from 1984 to 1987, the United States and Japan had roughly equal rates of manufacturing productivity growth, though our consumers still seem to question U.S. manufacturing quality.

There are also indications that the U.S. position in science and technology had declined. The number of U.S. patents awarded to U.S. inventors dropped from 73 percent of the total in 1970 to 52 percent in 1987. The portion of scientific and technical articles published worldwide by American authors shows a similar decline. With twice the population, the United States trains roughly the same number of engineers as Japan. The United States deploys a few more engineers in research than Japan, but a far larger number in defense, leaving fewer engineers available for nondefense production in the United States than in Japan.

The Nation must invest in ideas and technology, as well as in education and infrastructure, to maintain its position in the growing world marketplace. Federal R&D funding has recently undergone drastic changes that may be inconsistent with this goal. From the mid-1960's until 1981, Federal spending for R&D was split evenly between defense and nondefense programs. Today, defense programs receive almost two-thirds of the R&D budget. This change in R&D priorities has implications for U.S. commercial strength because, as the CEA's report also noted, "spillovers from defense research into the civilian sector appear to have fallen off since the 1950's." Moreover, between 1980 and 1987, U.S. investment in nondefense R&D remained roughly constant at 1.8 percent of GNP, while West German and Japanese investment increased to 2.6 percent and 2.8 percent of GNP, respectively. The gap with Japan as a percent of GNP is the equivalent of about $55 billion in additional U.S. nondefense R&D spending.

The level of Federal funding for nondefense research should be increased; President Bush's proposals, such as one boosting funding for academic basic research through the National Science Foundation until the FY87 level is doubled, are constructive in this area. Tax incentives and antitrust waivers for cooperative efforts in the private sector should be examined. International protection of intellectual property should be strengthened. Finally, we should consider the desirability of the reallocation of Federal R&D funds and the growing relative share of the Department of Defense in federally sponsored industrial revitalization efforts such as SEMATECH and the National Center for Manufacturing Sciences.

MAINTAINING ECONOMIC STABILITY

The S&L crisis

Financial institution instability could be a serious threat to continuing economic expansion. Shoring up some of the Nation's shaky financial institutions would be an important investment in long-term stability and growth.

S&L's were established as a means to provide affordable credit to homeowners at a time when other lenders were unwilling to make long-term home mortgage loans. S&L's have played a major role in allowing American families to buy their own homes over the last 50 years. Most S&L's are profitable, but many have failed or become insolvent. The combined losses are estimated in the tens of billions of dollars. Proposals to rescue the depositors could cost as much as $150 billion.

A number of factors contributed to the present crisis. Among them were changes in the economy, especially the high interest rates of the late 1970's and early 1980's; competition from other financial institutions; imprudent and corrupt pactices by many S&L officials; and inadequate supervision by regulatory authorities and insufficient oversight by Congress. The drop in oil prices caused an economic downturn in the Southwest, exacerbating the problems for the S&L's in that region.

One of the questions that Congress needs to ask before it acts to bail out the S&L industry is how a recurrence can be avoided. The S&L crisis has been termed a case study of how not to regulate an industry. Surely, one lesson from this experience is the necessity for safeguards to accompany government deposit guarantees—and any other guarantees, for that matter—to ensure that prudent business practices will be followed and taxpayers do not again have to pay for business losses. Government policymakers must be more vigilant in every area against such slowly emerging long-term problems. Finally, we must carefully consider the long-run competitive and regulatory position of S&L's vis-a-vis commercial banks and other financial institutions and the capital requirements for all financial intermediaries.

International debt

Further financial institution instability is caused by the serious and prolonged debt problem with which both developed and developing countries have been struggling since 1982. During the late 1970's, many poor countries borrowed heavily (and many banks lent extensively) in the belief that strong growth and rising prices for Third World commodities would continue indefinitely. When the recession and deflation of 1981–82 halted these trends, banks abruptly ceased lending, just as high interest rates were increasing the interest payments owed by countries on their old borrowing.

This outward transfer of funds has made economic management more difficult for debtor countries. Between 1982 and 1985, the consensus among creditor countries was that debtors needed to "adjust" through austerity programs—to cut deficits, control imports, and expand exports. In the changed environment, income, investment, and growth in the debtor countries stagnated, and the previously large amount of U.S. exports to these countries decreased significantly.

The Baker Plan, announced in 1985, was a positive effort to shift the emphasis from austerity and adjustment to adjustment with growth. This approach relied on significantly increased new lending to debtor countries by both commercial banks and multilateral institutions, in concert with economic reforms. Four years later, the new lending has not materialized; at issue is whether reforms were undertaken. Now there is a growing consensus to find a new approach to the debt problem.

This new consensus centers on reductions in the debt and debt service burden of heavily indebted countries that genuinely implement efficient economic policies. This consensus has now been embraced by the U.S. Treasury, as evidenced by the recent speech by Secretary Brady endorsing voluntary debt reduction. It will take a number of months before the scope of voluntary debt reduction is clear, and important questions concerning the nature and extent of public involvement in debt reduction remain to be resolved.

The shift in strategy opens up new possibilities. Banks and the governments of both creditor and debt countries can negotiate new arrangements that improve resource flows for debtor countries, lower their stock of debt, put them back on a path toward creditworthiness, encourage democratic processes, and restore their ability to purchase U.S. exports.

ACHIEVING A BETTER AMERICA

Poverty

The U.S. poverty rate dropped fairly steadily from 30.2 percent in 1950 to an all-time low of 11.1 percent in 1973, based on the common measure using cash income only. It rose to 12.3 percent during the 1974–75 recession, fell back to 11.4 percent in 1978, then jumped to 15.2 percent in 1983 as a result of the 1981–82 recession. The poverty rate declined to 13.5 percent in 1987 (the latest data available) as a result of the economic recovery. The puzzle is that poverty is still so much higher than in the 1970's, even though unemployment is now significantly lower.

Considerable progress has been made in reducing the poverty rate among the elderly from 35.2 percent in 1959 to its historical low of 12.2 percent in 1987. Less favorable is the path of the poverty rate among children; it dropped from 26.9 percent in 1959 to a historical low of 13.8 percent in 1969, rose to 21.8 percent in 1983, and declined only to 20.0 percent in 1987. Fifteen percent of poor families were headed by a person working year-round (more than 49 weeks per year) and full-time (more than 34 hours per week). One reason for the lack of progress in reducing poverty is that real earnings for year-round, full-time workers have shown far less growth since the early 1970's than in the 1950's and 1960's.

Of increasing concern is the plight of a widening "underclass." This term is generally used to designate a group of Americans having a long-term or even multigenerational existence apart from the economic and cultural mainstream. This group includes both rural and urban Americans of all races. Among the problems faced by different groups of the underclass are broken families and illegitimacy, educational failure, geographic isolation or concentration, welfare dependency, absence of local economic opportunity, and racial discrimination. Underclass children grow up within cultures in which few adults hold regular jobs, and thus have few role models to emulate when they approach maturity. Disorderly schools and the drug trade thwart even the most conscientious attempts at getting an education.

At the same time, advancing technology increasingly places many jobs—even at the entry level—beyond the reach of those lacking an education. Conscientious attempts at self-improvement—as well as the work ethic—are further undermined by oppressive housing conditions, unsafe neighborhoods, and severely limited local economic opportunity which make all the more alluring the quick, easy money offered by criminal pursuits. Integration of the underclass into society is not only a moral imperative, but it also would aid the economy by expanding the productive work force urgently needed by today's businesses to compete in a changing global marketplace.

Because poverty is a multifaceted problem, it has no single solution. Poverty among the elderly and disabled could be reduced in the short run by increasing Supplemental Security Income; estimates put the price tag of eliminating poverty among these groups at between $5 billion and $10 billion per year. Those who are poor because of unemployment need jobs; those who are poor despite hard work need faster real wage growth; both need training skills, and literacy. Because real wages have typically followed productivity, boosting real wage growth requires improving productivity growth, possible only through greater savings, technology, and skills.

Clearly, a most urgent concern is the insulation of the current generation of underclass children from the dispiriting effects of their environment. Children must have safe, orderly schools in which to learn. They must have adequate nutrition, health care, and housing. They must be supervised outside of school hours, either by their families or through quality day care. Breaking the cycle of dependency will be neither easy nor cheap; cost estimates for expanding only education and health programs with proven track records in benefiting children (making no allowance for increased cash assistance) extend upward to $20 billion per year.

In addition to improving aggregate economic performance and programs directed to underclass children, government has a role in helping to reduce the mismatch between the skills of the poor and those required by increasingly sophisticated technology in the workplace. Adult education, job training, and improved literacy can especially benefit both individual members of the underclass and the society as a whole. Such programs, like the Job Training Partnership Act (JTPA) and the recently enacted Family Support Act, help to bring the poor into the productive labor force. However, even small programs like JTPA, which serves those most likely to succeed, cost between $4,000 and $5,000 per job placement.

Homelessness

Today, the Nation faces what President Bush and Secretary of Housing and Urban Development Jack Kemp have called the "appalling tragedy" of homelessness. According to David Maxwell, Chairman of the Federal National Mortgage Association, over one-fourth of low-income renters now pay more than 75 percent of their income in rent. Some have been forced onto the streets. Thirty-four percent of the homeless today are families with children, and 23 percent of homeless adults are employed.

As noted in the President's inaugural address and earlier in the Congress' remedial legislation, the plight of the homeless requires special attention. Full funding for the McKinney Act, as proposed by President Bush, will address the emergency situation found in many cities and outer-urban areas; but providing large taxpayer-maintained shelters is not a long-term solution.

The record of public housing and other programs for the poor has always been a subject of much debate; and during the 1980's, the Federal Government scaled back assistance for public housing in favor of more market-oriented solutions. The ultimate answers to these issues are still unclear. Preserving and upgrading the maintenance of the existing stock of low-income housing is a pressing concern. Section 8 contracts were provided under varioius terms starting in 1974, and subsidy contracts with landlords expire after 15 years. The loss of these units would reduce the Nation's dedicated low-income housing stock. At issue is whether the Section 8 program is an effective means of providing affordable housing.

Giving tenants more voice in the management of their housing could be an innovative, inexpensive way to maintain the quality of the current stock of low-income housing. Another option might be to sell public housing to its tenants, giving them a financial stake in their homes. "Urban homesteading" programs can save homes from abandonment. However, efforts to preserve low-income and moderate-income housing still need to be augmented by programs to strengthen neighborhoods, including better employment opportunities, better crime prevention, better schools, and better infrastructure.

Health care and the challenge of an aging population

The United States today needs to make possible adequate health care to the millions of Americans who are not covered by health insurance and to the rapidly growing population of older Americans, while somehow controlling escalating health care costs. Health care expenditures in 1988 totaled about $550 billion, more than 11 percent of GNP. By the year 2000, it is estimated that health care expenditures will rise to $1.5 trillion, equal to 15 percent of the projected GNP. Last year, the medical care component of the CPI rose 6.9 percent, almost 60 percent faster than other prices. Thus, even if its health care needs were being met in full, the Nation would be hard pressed to provide adequate financing over the long term. Much of the initiative for controlling health care costs must come from the private sector. Government initiatives to expand access to health care should operate in the most efficient and least costly manner.

Despite these large expenditures, however, millions of Americans do not receive adequate medical care. Although we spend, as a percentage of GNP, more than any other country and about 50 percent more than the average for the 22 industrialized countries of the Organization for Economic Cooperation and Development, the United States ranks 20th among its 22 countries in infant mortality, and is in the bottom third with respect to life expectancy at birth. And 37 million Americans have no health insurance, a problem where any solution would have enormous cost. For example, providing Medicaid coverage for today's uninsured would cost roughly $50 billion per year; about three-fourths of the amount would pay for services already received by this group, and the remaining one-fourth would pay for additional services now foregone because of their lack of coverage.

The problems of controlling health care costs and improving the health of the population are complicated by the rising number of older Americans with special medical needs. The percentage of the population age 65 and over is projected to increase from about 12 percent today to about 23 percent by the year 2050. The percentage of persons age 85 and over will increase even more dramatically, from one in 100 today to a projected five in 100 by the year 2050. However, because the most rapid rise in the number of older Americans will not occur until after the year 2000, the United States can prepare for the health care and other costs associated with an aging population. Within the next 30 years, the number of older Americans needing nursing home care may almost double. We should begin now to explore ways of paying for this health care delivery system, including more cost-effective methods such as community-based, in-home care.

The environment

Man's capacity to degrade his environment—quickly but with potentially disastrous long-term consequences and in ways which are not fully understood at the time—has grown to sobering proportions. Ignoring emerging problems merely compounds the ultimate human and economic costs. Public policy must repair past damage and avoid future damage by making long-term investments in the environment.

While many environmental problems affect specific geographic areas, an increasing number appear to have global effects. Perhaps the most obvious of these is the possibility of ozone depletion and global warming. Drought conditions in the major grain-producing areas of the country have brought immediate attention to what used to be seen as a less pressing problem. There has been an increase in domestic and international efforts to find means to limit warming trends. Market forces can contribute to this process, but are only part of a solution that will require international cooperation.

In the past, most environmental policy has been in the form of laws and regulations mandating particular standards. Economists have long recommended the use of market-based incentives to supplement the regulatory approach. Recently, environmental groups have also begun to assess the usefulness of market approaches as a means of improving environmental quality. Market-based approaches, in contrast to regulations, have the advantage of altering the basic incentive to pollute by forcing people and firms to explicitly absorb the costs of their actions. Where market forces are appropriate, they have the advantage of not requiring a significant amount of policing by the government once they are implemented.

Many believe that economic incentives can address a number of environmental problems, but they will not be a panacea. Nonmarket approaches will be required in cases like carbon emissions, where international cooperation is needed, or nuclear waste, where hazards are long-term and potentially catastrophic. In addition, a number of environmental problems cannot be resolved through regulations or markets. For example, in the case of sewage treatment plants, the basic issue is deciding how to pay collectively for necessary facilities.

Finally, though the importance of protecting the environment is great, the cost is truly daunting. Cleaning up the wastes of U.S. nuclear facilities, a small piece of the environmental agenda, is projected ultimately to cost at least $50 billion. Bringing municipalities into compliance with Federal clean water standards will cost another $24 billion. While some of these and other necessary environmental costs will be borne outside of the Federal sector, the total costs to society, and even the Federal share, will surely be enormous.

CONCLUSION

To afford the costs of a better America, we must achieve robust and stable economic growth over the long term. This will involve the considerable costs of public and private approaches not only to fight poverty and homelessness, deliver medical care and safeguard our environment, but also to improve our educational system, develop new technologies, renew and expand public infrastructure, and restructure unsound financial institutions. These investments may yield little gratification in the near term, but they are essential to our continued leadership and prosperity in an increasingly competitive world.

V. FUTURE DIRECTIONS

The beginning of a new Administration and a new Congress is a good time to take a broad, long-term view of the Nation's economic policy.

THE BETTER AMERICA

The concerns identified in this Report section are shared by both political parties.

Progress against poverty would not only yield the pride of a society that proved itself kind and gentle; it would also spare every one of us some of the pain of crime and decay, and give us the fruits of the labor of a larger and more productive work force. In a Nation that spends far more than most on its medical care and serves its poor and its old, too many other citizens fall through the cracks. Medical care costs are rising too rapidly, and the growing population of elderly will press the system still harder. Homelessness is an appalling tragedy. And our environmental concerns range from the aesthetic qualify of life to survival.

Resolving these issues would be gratifying because it would provide testimony to the greatness of this Nation. But beneath this exalted view lies the cold reality that our success in these endeavors (for that matter, in our national defense) must be based on our strength as a productive economy. We need continued economic stability because an early recession would swell our budget deficit and postpone our best efforts. We also need faster economic growth to devote greater resurces to all of our national priorities.

MAINTAINING ECONOMIC STABILITY

Policymakers have much to be proud of in the performance of the economy during the current recovery. Since the 1982 recession, real GNP has grown at about 4 percent per year, and more Americans are working than ever before. Consumer price inflation has remained low (about 4 percent per year through six years of recovery, with a modest creep upward in the past two years), even while unemployment has fallen to a 15-year low.

Still, the challenge of maintaining employment growth and containing inflation is greater today, in an economy close to full employment and showing early signs of an upturn of inflation, than it was when there was considerable slack and inflation was dormant. The Fed has less margin for error: an easy monetary policy is more likely to produce inflation than additional real growth in today's economy, but excessive monetary restraint could derail the recovery.

Over the last two years, the economy had begun a healthy transition to growth based on investment and exports. However, that transition may have stalled in late 1988; investment and exports slowed. If this development is confirmed by further experience (the signals are still tentative), it will limit potential growth and demand more care in economic policymaking.

This Committee's major focus in on the long term rather than the "here-and-now," but there is one important long-term issue that also plays a key role in short-term economic stabilization—the Federal budget deficit. The large deficit, coupled with low private savings, gives us our lowest rate of national savings in the post-World War II period. Further, with our large government deficit and high real interest rates at this stage in the expansion, we confront the private sector with an unprecedented economic environment, which creates uncertainty and makes business planning more difficult.

INCREASING ECONOMIC GROWTH

The Federal budget deficit is more a long-term than a short-term issue because it slows economic growth. In theory, the Nation could achieve solid growth with a large budget deficit by expanding private domestic savings to finance both the Federal budget deficit and substantial private investment as the West Germans and Japanese have done. In practice, however, the level of U.S. private savings has been low, and has fallen as a share of national income even in the present recovery with its high real interest rates.

The Federal budget deficit represents a large drain on this already shallow pool of national savings. Foreign savings so far have replenished that pool and allowed investment to remain at its prior level. But future U.S. incomes will be lower than if that same investment had been financed with our own additional savings. If we reduce the budget deficit, interest rates can come down, encouraging more investment; any continued foreign lending will add still more to the savings available to finance future growth.

The Nation has struggled with uncomfortably large budget deficits for more than a decade. Over that time, the Congress and the Administration have expended considerable effort, but the task is incomplete. If the first deficit reduction steps chosen were the easiest, as most likely they were, then the hard choices remain.

A second route toward faster economic growth is improved education. A highly skilled work force can better utilize technological advances, which often are also pioneered in our high education system or through the skills that education imparts. Still, the quality of our students at that level is determined earlier—in secondary, elementary, and preschool education. And further, basic literacy must be addressed at the early levels of education, along with remedial efforts for today's adults through adults education. Our efforts to improve our educational system must touch every level—from ensuring access to higher education to providing the best preschool preparation—and we must expect that these endeavors will take some time to pay dividends in the economy.

Of course, educaiton is not merely an economic investment; it is also a part of the better nation that we seek. An important payoff could be broadening the horizons of the growing numbers of underclass children who would otherwise be permanently consigned to a culture of economic and intellectual poverty and perpetuate the cycle.

A third route toward faster economic growth is investment in ideas and technology. While the United States has the highest *level* of productivity in the world, other nations have been closing the gap. Out productivity growth has recovered partially from its slump of the 1970's, but our growth rate is still generally below our competitors. Other nations can advance rapidly by copying our technology, but we should exert every effort to maintain our lead. Our level of civilian R&D spending as a percentage of GNP is lower than that of our major competitors, and we face important choices regarding the allocation of our R&D effort between defense and nondefense categories, and among several specially created research consortia and preexisting government, nonprofit, and business organizations. Whatever our ultimate choices, there is little doubt that development of new technology will prove crucial to a nation that seeks to continue paying the world's highest wages to its highly skilled labor force.

Finally, government at all levels can contribute to growth by providing business with a sound infrastructure base. Our transportation and water systems should be kept at peak efficiency. That will require maintenance and refurbishing of existing facilities, expansion of facilities as growth requires, and innovation.

CONCLUSION

Our Nation's ambitions extend beyond today. Realizing those ambitions, therefore, will require our best efforts today and well into the future. For all of our differences, the Members of this Committee join in seeking common paths to the better America we all want.

MAJORITY VIEWS

I. Introduction

A nation's economic strength is important for many reasons. Over the long term, how much a nation can produce can determine its success in a broad range of endeavors—from providing for its own defense and exerting influence around the world to caring for its poor and providing prosperity and opportunity for its middle class. Thus, a sound and growing economy is in the interest of every American, regardless of ideology.

This Committee's Report presents a core understanding of the state of the U.S. economy, based on fact and widely accepted interpretation. This understanding includes both strengths and weaknesses, and the Democratic Members of the Committee acknowledge both. However, as we consider these facts, we are left with one inescapable conclusion: The Nation needs a new economic policy.

The United States is the world's greatest economic power. However, our margin over our competitors is shrinking. Our current economic policies are based, unintentionally to be sure, on the pursuit of gratification in the short run rather than on strength over the long term; a successful economy prepares for the future, but so far in this decade, we have failed to do so. These same policies may make even our short-term gratification unsustainable; we have reduced flexibility to deal with any economic shock. The time to right these policies is now, when the economy is growing; once any shock occurs or any imbalance arises, the process will be much more painful.

The major indicator of our reduced preparation for our future has been our reduced rate of savings over this decade. The single major contributor to this decline is unquestionably the Federal budget deficit. Borrowing to finance the deficit removes funds from the credit markets, raising interest rates for private borrowers financing homes and business investment. The deficit adds to the National debt, which is now triple its level at the beginning of the decade. This additional debt must be served in perpetuity.

The increased Federal deficit, along with reduced private savings, led the Nation to consume more than it produced—and thereby generated massive trade deficits. Financing the excess of our purchases of imports over our sales of exports has made us dependent upon credit from abroad. This dependence creates a major vulnerability for the economy in the short run. It also reduces our incomes in the long run, as increased interest and dividend payments to foreign owners of U.S. assets have almost caught up to our investment income from abroad. And because this foreign credit has financed greater consumption, not investment, we will have no greater future incomes out of which to pay foreigners the returns on their investments.

At the same time that the Federal deficit has detracted from the availability of capital for provate investment, Federal spending has shifted away from public investment. Spending for important categories of education, infrastructure, energy, and the environment has been either cut in nominal dollars or increased too little to compensate for inflation. Many analysts, including the Council of Economic Advisers, agree that neglect of public investment can detract from economic growth.

The cause of the growth of the budget deficit is a matter of controversy, but the evidence indicates that it is not an expansion of non-interest spending. Solving the deficit problem is a matter of the highest urgency, both to maintain economic stability in the short run and to promote economic growth in the long run. The Gramm-Rudman-Hollings procedures have encouraged more manipulation of deficit accounting then actual deficit reduction; postponing the problem in this manner really means that we will pay the bill later with interest. The ultimate solution will require more willingness to make the difficult choices than procedural skill. We find that the Administration's recent budget proposals do not adequately address either the deficit problem or the priority for public investment.

The rates of job creation and family income growth are not improved under the current policies compared with the 1970's, and poverty, income inequality, homelessness, and middle-class housing affordability are worse. Policy needs to address these issues to avoid the worsening of a trend toward to a two-tiered society.

Now, with a new Administration and Congress and a growing economy, we have a window of opportunity to deal with these crucial economic issues. With the compounding of our public debt and the vulnerability of the economy to any external shocks, that window will not remain open indefinitely. It would be far better if we address these concerns now, rather than waiting for events to overtake us.

II. CURRENT FISCAL AND MONETARY POLICY

The goal of these Majority Views is to look forward to the economic policy choices faced by the new Administration and Congress. However, to do so, it is essential to understand the current state of the economy and the economic policies that brought us to it. Here, the major emphasis will be on macroeconomic policies—those that influence the course of the economy as a whole. These include fiscal policy (the amount of Federal taxes, spending, and the budget deficit) and monetary policy (the control of the availability of credit exercised by the Federal Reserve). A further concern will be the priorities embodied in the budget itself.

FISCAL POLICY

The Report cited the growth of debt in all sectors of the U.S. economy as an area of uncertainty; it documented the decline of private savings and the growth of the Federal deficit, and their combined effect in the decline of national savings. We would go further and state that the major source of the rise of debt is the Federal Government's fiscal policy, and that the rise of debt has created an important structural imbalance.

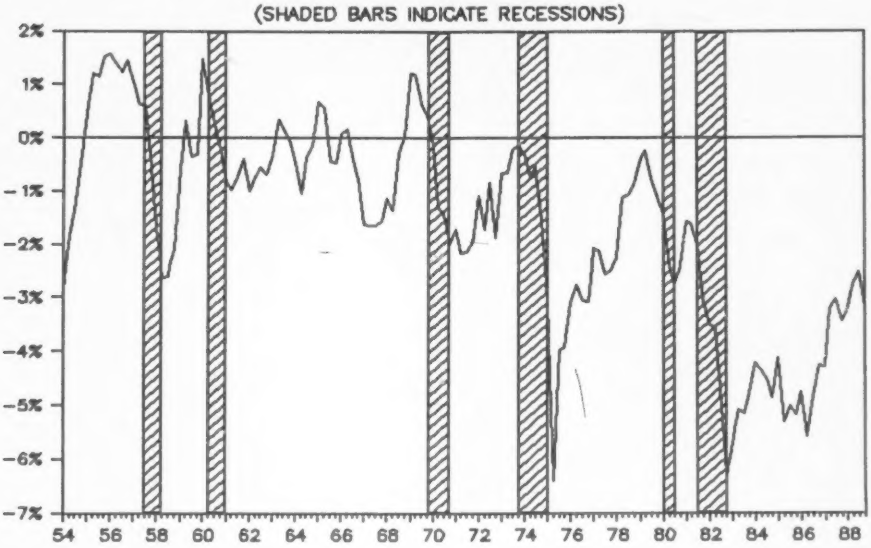
Figure 5 shows that the Federal deficit has been much larger in the current recovery than in the past, and that the deficit has persisted far later in this recovery than has been the norm. This holds true even if the Federal budget deficit is consolidated with State and local government budget surpluses, as in Figure 6.

FIGURE 5

FEDERAL GOVERNMENT DEFICIT

AS A SHARE OF GNP

(SHADED BARS INDICATE RECESSIONS)



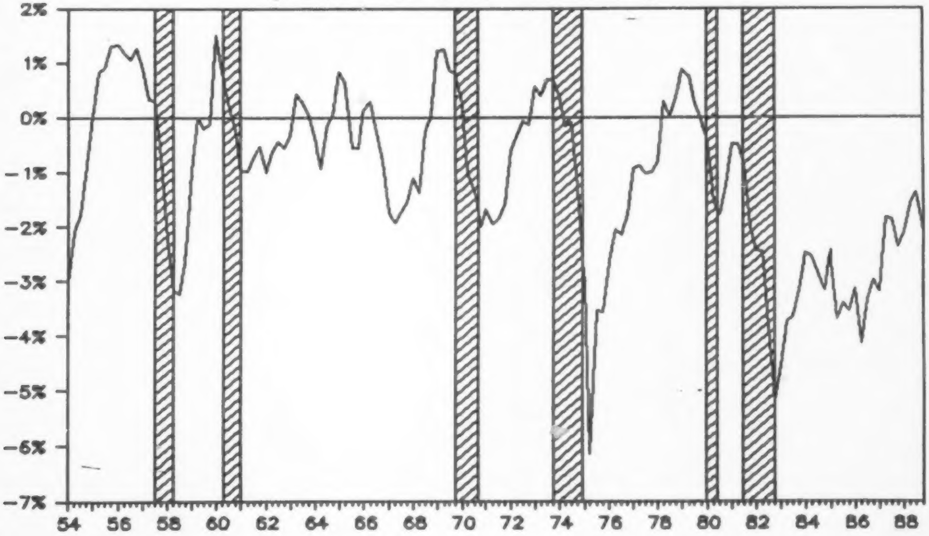
Source: National Income Accounts

FIGURE 6

TOTAL GOVERNMENT DEFICIT AS A SHARE OF GNP

FEDERAL PLUS STATE & LOCAL DEFICITS

(SHADED BARS INDICATE RECESSIONS)



Source: National Income Accounts

From the end of the economic expansion in 1979 until 1988, U.S. gross savings—an important measure of our preparation for the future—declined from 18.3 percent to 13.2 percent of GNP. Over the same period, the Federal deficit increased from 0.6 percent to 2.9 percent of GNP (on a comparable calendar year basis). Thus, the increase in the Federal deficit is responsible for almost half of the total decrease in gross savings; no other single factor is responsible for nearly as much. This large reduction in our savings rate has serious economic consequences.

Federal outlays rose from 20.6 percent of GNP in 1979 to 22.3 percent in 1988, while revenues increased from 18.9 percent to 19.0 percent. Some analysts use these figures to argue that the deficit is a result not of low taxes, but rather of too much spending. However, this assessment ignores important shifts in the composition of Federal revenues and expenditures.

Net interest payments grew from 1.3 percent of GNP in 1954 to 1.7 percent of GNP in 1979, but then accelerated to 3.2 percent in 1988, as the large shortfalls of revenues relative to outlays expanded both the national debt and the costs of servicing it. Net interest is a mandatory expense; the Nation has no choice but to fulfill this legal obligation. The cost of social security was only 0.9 percent of GNP in 1954; by 1979, the combined costs of social security and the Medicare program were 5.3 percent of GNP, rising further to 6.2 percent in 1988. Social security and Medicare are supported by a broad consensus that includes both political parties; and they are financed almost exclusively by their own payroll tax, which presently provides a reserve against future obligations.

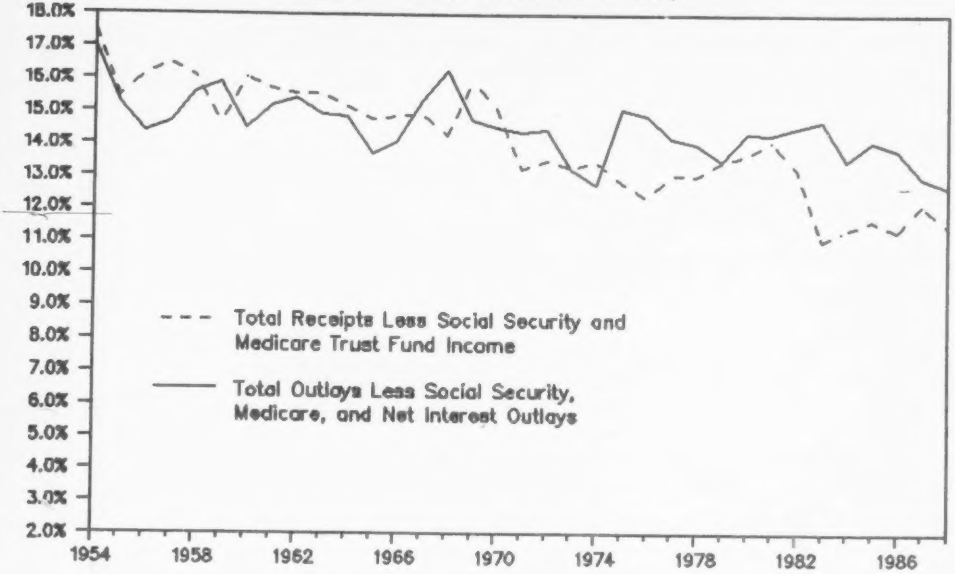
The clearest view of the relative roles of spending and taxes in the rising deficit excludes net interest, social security, and Medicare. In fact, spending on all other Federal Government activities has declined as a share of GNP, from 17.0 percent in 1954, to 13.6 percent in 1979, and to 12.9 percent in 1988, as shown in Figure 7. The deficit grew over this period only because revenues (excluding social security and Medicare payroll taxes) declined even more—from 17.5 percent of GNP in 1954, to 13.4 percent in 1979, and to 11.4 percent in 1988.

Thus, the Federal deficit is not fundamentally the result of increasing spending—on either social security or other non-interest programs—but rather of a growing shortfall of non-social security revenues relative to declining non-social security, non-interest spending, plus increased interest obligations because of this shortfall.

FIGURE 7

FEDERAL RECEIPTS AND OUTLAYS:
EXCLUDES SOCIAL SECURITY, MEDICARE & NET INTEREST

(FISCAL YEARS; PERCENTAGE OF GNP)



Source: Calculation based on data from OMB

BUDGET PRIORITIES

Figures in the Report further document this shift in the composition of the budget. The fastest growing budget item over the 1980's has been net interest—which buys the Nation nothing other than peace with its creditors. Also growing rapidly has been defense; and while the national defense is a necessary objective, many of us believe that spending toward that objective has been excessive. Social Security and other entitlements have declined slightly as a percentage of total spending.

Spending cuts have hit hardest in the "other" category—mostly referred to as "nondefense discretionary" programs. This mundane-sounding category includes some of the programs most necessary to a sound economic future.

The prime example is education. All forecasts point to a coming shortage of skilled labor. At the same time, as the Report noted, elementary and high school dropout rates average 25 percent. The dropout problem, as well as other educational weaknesses, is not distributed uniformly across the country; rather, it is concentrated in localities where resources are scarce and the cost of obtaining the best teachers is high. The core of the Federal role is providing equal access; it is imperative both for fairness and for a competitive labor force that we bring the weakest educational systems up to speed. But over the 1980's, the number of Federal dollars devoted to education has been cut by more than 5 percent, while the general price level has increased by about 30 percent.

American business cannot prosper without infrastructure. As was documented in the Report, U.S. infrastructure investment has not kept up with the wearing out of our existing roads, bridges, water ports, and airports, much less provided for future needs. Federal spending on ground transportation was lower than 1981 levels over much of the decade, and is now increased by a margin well short of what would be needed to compensate for inflation.

Other budget priorities have been seriously neglected. Despite the dire consequences of a future interruption of our energy supplies, energy conservation expenditures were cut by more than half over the 1980's (unadjusted for inflation). Pollution abatement expenditures have been cut in nominal dollars. And resources for law enforcement have clearly been insufficient to control a growing drug problem.

MONETARY POLICY

Besides fiscal policy, the other major tool of macroeconomic policy is monetary policy (the control of the supply of credit in the economy). The Federal Reserve introduced the Nation to a restrictive monetary policy and its resultant high real interest rates (the excess of the interest rate over the inflation rate) in 1979 to control inflation. This created a deep recession and an abrupt decline in the inflation rate by 1982. For the rest of the 1980's, however, the Fed maintained high interest rates as a counterweight to the large budget deficits, to keep the economy from expanding too rapidly and igniting inflation.

The tightness of monetary policy is best measured by the level of real interest rates. On average over the 1980's, interest rates on the highest rated corporate bonds exceeded inflation by over five percentage points—more than in any year in the 1970's. High interest rates make it more costly for businesses and households to invest in factories, machinery, or housing.

CONCLUSION

In summary, our current large budget deficit, well into an expansion, is unprecedented. Our real interest rates are at record-high levels. So the combination of these two policies, a highly stimulative fiscal policy and a highly restrictive monetary policy, is clearly beyond the realm of our experience.

III. NEAR-TERM RISKS OF CURRENT POLICY

While we cannot predict the long-run or even the near-term course of the economy given our unprecedented large budget deficit and high real interest rates—we sailed off the edge of our policy charts several years ago—our uncertainty is even greater due to the growing risk of a recurrence of inflation.

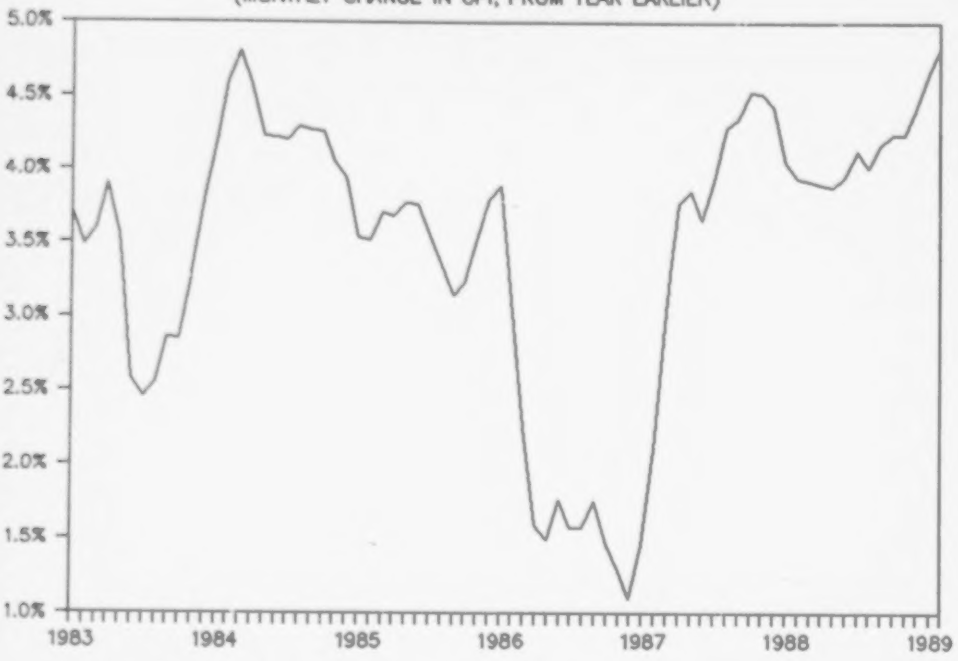
INFLATION

The Report cited moderate inflation as a strength of the economy, while noting that inflation is not low enough. Now, however, inflation may be accelerating once again. Figure 8 demonstrates that there has been no real progress in reducing inflation since 1983. The inflation rate hovered around 4 percent, dipped because of falling oil prices in 1986, and then increased steadily during both 1987 and 1988 back to about 4 percent. January and February 1989 have been particularly disturbing—with a full percentage point rise in the PPI each month and a rise in the CPI at a 6.1 percent annual rate.

FIGURE 8

INFLATION RATE

(MONTHLY CHANGE IN CPI, FROM YEAR EARLIER)



Source: Bureau of Labor Statistics

Pressure on inflation is broadly based. Capacity utilization is high, particularly in export industries. Strong worldwide demand is driving up commodity prices. World food supplies are questionable after last year's drought. Employer labor costs are also moving higher, driven by large increases in the cost of health insurance and other fringe benefits. Last year alone, health care costs rose by more than 10 percent. Interest rates are also rising, adding to business costs.

A resurgence of inflation would threaten the economic expansion. The Federal Reserve could feel compelled to raise interest rates further to slow the economy and thereby prices. Indeed, there is great concern that the monetary tightening undertaken already will throw the economy into a recession.

STRUCTURAL RISKS TO THE ECONOMY: FINANCIAL FRAGILITY

Deregulation in the 1980's produced significant efficiency gains for a number of industries, such as trucking, telecommunications, and natural gas. But as the Report suggests, deregulation, as practiced, has jeopardized the safety and soundness of the Nation's financial system. Banks and S&L's were freed from old restrictions on the interest rates they could pay depositors, and allowed to compete freely with one another and to hold more speculative investments. This put heavy pressure on regulatory agencies. With few precise rules, regulators had to rely on their own judgments. Without the staff resources or expertise of the institutions they supervised, regulators were unwilling or unable to challenge those institutions. As a result of these factors and Federal deposit guarantees, risky and speculative investments were made in all parts of the financial system, creating extreme fragility. The problems of S&L's are now widely known, but commercial banks have also accumulated significant amounts of questionable debt, including loans to Third World countries, commercial real estate ventures, and heavily indebted corporations.

The corporate sector in general shows unsettling signs. Mergers and hostile takeovers have proliferated, as have "leveraged buyouts" by corporate management. Firms have replaced equity with debt at a record pace, contrary to the usual pattern of adding to their equity base during economic expansions. In 1988, for the third year in a row, the value of corporate debt downgraded by Moody's investment rating service exceeded the value of debt upgraded by more than two to one. Nearly half of all corporate debt outstanding in 1988 was rated as "speculative," as opposed to less than 10 percent at the start of the decade. While the corporate sector used to be somewhat insulated from short-term credit-market fluctuations, now even very large corporations have enormous debt-servicing obligations that make them vulnerable to adverse developments in financial markets. While some analysts believe that today's highly leveraged corporations could survive a recession, or that both the corporations and the economy could survive even a rash of bankruptcies, we should not wish to test these hypotheses.

INTERNATIONAL ECONOMIC IMBALANCE

Each of our problem areas—large Federal budget deficits coupled with tight monetary policy, a possible accelerating inflation, and unstable financial institutions—poses a risk to the economic expansion in the near term. Of greater concern is the way in which these risks reinforce and compound each other, and how they weaken our ability to respond to any economic shock.

Policy has created an environment without precedent, in which our economy depends upon untested relationships and institutions for support. Important among these relationships are those between the Federal Government and its creditors, the Nation and its creditors, and the corporate sector and its sources of finance. Key institutions intermediating these relationships are the newly deregulated and innovating financial markets. At the center of this policy maelstrom is the interaction of the budget deficit and our tight monetary policy.

The large and continuing budget deficits, by themselves, complicate the making of economic policy. In the 1980's, these budget deficits contributed to a new dependence on foreign credit, which makes our economic environment even more volatile.

Dependence on Foreign Credit.—The budget deficit is negative savings. Figures 1 and 2 in the Report depicted both the large increase in the budget deficit and the decrease in private savings that occurred in the 1980's. An unprecedented development of this decade is that our savings fell so far that our spending exceeded our production. The excess of our spending over our production necessarily goes for imports; in other words, we have been running a trade deficit. We can pay for what we buy over the above our production only by either selling our accumulated assets to foreigners or borrowing from foreigners.

In 1988, the United States needed to borrow $135 billion from abroad; our cumulative borrowing since 1982 has been over $700 billion. For most of the post-World War II period, the United States has been a lender to the rest of the world, because we had more savings than we needed domestically. As a result, we acquired more assets around the world than foreigners acquired in the United States. In the 1980's, that relationship reversed. Whereas U.S. investment income on our assets overseas used to exceed foreigners' investment income on their assets in the United States by a substantial margin, those flows are now virtually equal.

High Interest Rates.—The United States has attracted the foreign credit it needed because it has offered high interest rates. Unfortunately, the high interest rates are hard on the domestic economy. They make business investment more costly, and they put a crimp on growth in other credit-dependent sectors of the economy, including housing and agriculture.

Pressure on the Dollar.—For foreigners to invest in dollar-denominated U.S. assets, they must first buy dollars. That drives up the value of the dollar, and thereby increases the prices of U.S. exports overseas, and reduces the prices of foreign goods here. Between 1980 and 1985, the dollar rose by 40 percent—the equivalent of a 40 percent tax on U.S. exports and a 40 percent subsidy on foreign imports—and widened our trade deficit. Between 1980 and 1985, real exports remained essentially flat, while real imports soared by 42 percent. This meant that export- and credit-dependent regions and sectors of the economy were left behind in the initial stages of the recovery. The industrial Midwest, the farm belt, and the natural-resource-based economies of the Rocky Mountains and Pacific Northwest all remained depressed through the middle of the decade, well into the overall economic recovery. U.S. manufacturers lost their positions in markets around the world and have had to struggle to regain them ever since.

This, in sum, has been the pattern of the 1980'—large Federal budget deficits contributing to reduced national savings, a trade deficit, and massive borrowing reducing the Nation's net wealth. The meaning of this pattern has been subject to differing interpretations—some more favorable to our future economic prospects, some less favorable. On at least two points, we believe that the facts are troubling.

The Cause of Foreign Capital Flows.—On the first point, we believe that the net foreign capital inflow that began in the early 1980's was drawn in by the high interest rates caused by large Federal budget deficits and the reduction of the Nation's savings, not by extraordinary physical investment opportunities in the United States—construction of factories or commercial buildings, for example. If foreigners were responding to new U.S. opportunities, then we would expect their investment to *add* to the prior level of domestic investment, leaving a large net increase. However, as Figure 1 in the Report makes clear, investment in the 1980's has been no greater than in the expansions of the 1970's. Thus, the United States has borrowed large sums overseas over the 1980's, but has not invested in more capital to make us richer and stronger in the future, only consumed more. As a result, the Nation has accumulated greater liabilities on which it must pay interest in the future.

Financial Market Volatility.—The second point is that a flow of foreign capital that is drawn into the United States by a reduction of savings rather than by irresistible investment opportunities creates short-term vulnerabilities as well. Whenever international investors (including Americans deciding where to park their money) begin to find U.S. financial assets less attractive then foreign assets, the Fed is faced with a difficult choice of letting the dollar fall or raising interest rates to keep the funds here. And the effort to balance these objectives may not be successful. Some observers attribute the October 1987 stock market crash to a crisis of confidence in U.S. assets: high interest rates moderated an outflow of funds, but they also pulled money out of the stock market. The economy survived this episode better than most analysts would have predicted, but the vulnerabilities remain and we may not have the same good fortune the next time.

Foreign lenders could change their attitudes toward the United States in the same way as any creditor toward any borrower: as the borrower takes on more debt, the most cautious lenders lose interest, and the other demand higher interest rates as compensation for the risk that the debt might prove too burdensome to repay. For foreign creditors, however, there is a risk not only in the value of their investments in dollars, but also in the value of the dollar relative to their own currencies. Any individual foreign investor who believes that the dollar will fall has every incentive to liquidate his investments and get out of dollars. That could make the dollar fall, and could induce still other investors to sell their dollar-denominated assets, reinforcing the dollar's decline.

Loss of Policy Flexibility.—The need to attract foreign capital reduces the Fed's flexibility to deal with domestic economic problems. If the economy slows, the need to hold interest rates high to keep the dollar attractive to foreigners may inhibit the Fed from providing easier monetary policy and lower interest rates to restore growth. Lower interest rates are also desirable to reduce the strain on highly leveraged U.S. corporations and shaky S&L's, but a drop in interest rates might precipitate a withdrawal of needed foreign credit.

Too Much Risk.—Given all these risk and uncertainties, the last five years do not prove that foreign credit terms will remain favorable indefinitely, any more than a five-year-old life insurance policy proves that a family breadwinner can prudently stop paying the premiums. The question boils down to how much risk the Nation is willing to run; we believe that the risk in current policy is excessive.

So the combination of the U.S. fiscal policy imbalance (the large budget deficit) and the compensating tight monetary policy (with high interest rates) has cost us jobs and markets and made our producers vulnerable to foreign competition as never before. It also make us dependent on foreign credit, and cuts off our options in the event of any economic shock. The Nation must find a way out of this policy box.

POLICY CHOICES TO REDUCE NEAR-TERM RISKS

The risk associated with our current policies present us with a new challenge: The Nation has always wanted strong economic growth, but we now need a particular *kind* of growth, concentrated in investment and exports, not consumption. We believe that such a favorable composition of growth is far from certain in today's economy. Thus, if we cannot devise policies which stimulate the right kind of growth, we risk reigniting inflation and unraveling the entire economic expansion. Further, especially as long as our policy imbalances remain, it is imperative that we head off potential economic shocks.

Trade and the Budget Deficit.—The first priority for economic stability is to reduce the Nation's dependence on foreign credit. Some would argue that forces are already in motion to accomplish that objective by cutting the trade deficit; we are skeptical.

There has been some improvement in the trade deficit, largely because of the decline in the dollar that began in 1985. However, as the Report suggested, the most dramatic improvement in trade may well be behind us. Exports grew sharply through the first half of 1988, but then slowed. The dollar has been relatively stable since the end of 1986, and it may have to fall still further to stimulate greater exports; but our dependence on foreign credit may inhibit that adjustment. In addition, surplus nations must reduce barriers to U.S. exports. The Special Trade Representative's Advisory Committee on Trade Policy and Negotiations has determined that Japanese barriers against U.S. goods alone account for up to 54 percent of our bilateral trade imbalance, and tough negotiations will be required. The Omnibus Trade Act of 1988 is helping to focus Administration attention to this challenge.

On the import side of the ledger, the United States spent more of its income growth on imports than any other industrialized nation in the 1980's, and there is no change of this pattern in sight. Foreign manufacturers have established a firm foothold in the U.S. market, and have held the line on their prices at the expense of their profit margins while their currencies rose relative to the dollar. Finally, our growing external debt requires ever-larger interest payments to foreign investors, which must be financed through foreign borrowing along with our trade deficit.

Thus, the only realistic way to end our dependence on foreign credit is to eliminate the gap between our savings and our investment; and it is far preferable to raise our savings than to reduce our investment. As was noted earlier, even reduced from its 1985 peak value, the Federal budget deficit is still responsible for almost half of the reduction of our Nation's gross savings. Thus, the deficit is the logical first target. Our dependence on foreign capital can also be reduced by increasing private savings, but Federal policy has had limited success in this area. It was during the 1980's when the most aggressive pro-savings policy initiatives were in place, that private savings declined (as shown in Figure 2 in the Report).

The budget deficit is a key issue in long-term as well as near-term economic policy issues, and will be discussed further in the next section.

Avoiding Economic Shocks: Policy Coordination.—The United States cannot make economic policy in isolation. Our economic policies over this decade have clearly opened our economy to the greatest degree since World War II; our trade deficit and dependence on foreign credit are the two clearest indicators.

The recently released International Monetary Fund (IMF) World Economic Outlook report emphasizes that the trade adjustment process, including the reduction of both the U.S. trade deficit and the large surpluses of Japan, West Germany, and other nations, has stalled. The IMF report cautions that the stability of the world economy is threatened if adjustment does not resume. To date, policy coordination among nations has been confined largely to exchange rate stabilization, and to reduction of the value of the dollar as in the Plaza Accord. Recently, however, the fundamental imbalances in the world economy have started driving the dollar back up, hurting American exporters and slowing trade adjustment. This should be taken as an urgent signal that policymakers around the world should coordinate fiscal and monetary policies as well as exchange rates.

Avoiding Economic Shocks: International Debt.—Democratic Members of this Committee have consistently favored a growth rather than an austerity approach to Third World debt. When then-Treasury Secretary Baker endorsed this position in 1985, we agreed with the shift in emphasis but questioned whether adequate funds would be forthcoming from commercial banks. When it became clear that the Baker Plan would not mobilize adequate new funding, congressional Democrats took the lead in proposing debt reduction as an alternative to restore growth. The 1987 Omnibus Trade Act provisions, calling for study of an International Debt Management Authority were but one expression of these views.

Now that Treasury Secretary Brady has accepted the principle of debt reduction, as described in the Report, we emphasize that debt management and debt reduction efforts must be comprehensive (dealing at one time with all of a country's debt); conditional (linking reduction to policy reform); coordinated (by some international body); and concerted (involving the participation in some form of all of a country's creditors).

Avoiding Economic Shocks: The S&L Crisis.—The ultimate cost of a solution to the S&L crisis remains unclear, though the trend of recent estimates is upward. The uncertainly has two causes. First, the industry's problems are dependent on the state of the economy; higher interest rates increase the number of thrift failures and the cost of a remedy. In this regard, the Administration's optimistic economic forecast is counterproductive. If assumption of falling interest rates lead to an underestimate of the cost of the program, it will delay the closing of failing thrifts, and the ultimate bill to the taxpayer will grow. The second difficulty is limited information. Both the Administration and the Congress provided insufficient resources for the monitoring of the industry after it was deregulated. This has contributed to both the onset of the crisis and the difficulty of its resolution.

The cost of the solution depends on the approach we choose. The most straightforward approach—with the least concern for the cosmetic effect on the measured budget deficit—is likely to be the cheapest. The Administration recommends that a Federal Savings and Loan Insurance Corporation (FSLIC)-related agency issue $50 billion in bonds over the next several years to finance the closure of hundreds of failed thrifts. The funds raised by the bonds would not be counted as spending (in effect, the proceeds of the sale of the bonds would be "revenue," offsetting the spending of the proceeds); only the interest paid on the bonds would add to the deficit. This proposal would have only a modest effect on the FY90 budget deficit, but it would aggravate future deficits, because interest rates for agency bonds would be higher than those for conventional Treasury bonds.

Despite the substantial cost, it is important that Congress and the Administration move swiftly to resolve this problem. Budgetary considerations should not be paramount, because funds raised to salvage the thrift industry will not have the same effect on the economy or capital markets as new spending. Federal funds will be used to make good on private deposits, which holders always assumed would be restored, and so the funds would not represent new stimulus to the economy. Congress must also prevent a recurrence of such errors elsewhere in the financial system. Adequate capital requirements for financial institutions and adequate support for regulatory authorities must be a part of any long-term solution.

In sum, there are risks to the economic expansion in the near term. No one can say for certain whether those risks will materialize. Nonetheless, we believe that the degree or risk in current policy is excessive, that our current path is most likely unsustainable because of fundamental economic imbalances, and that it would be prudent to change course.

However, near-term risk is not the only reason, or even the best reason, to change economic policies. More important is the need to prepare our economy for the future.

IV. Economic Policy for the Long Term

Many Americans have become increasingly aware of the importance of long-term economic growth. Several factors are responsible for this awareness. One is our Nation's changing role in the world economically, politically, and militarily. As other nation have developed and grown, often with U.S. assistance, they have provided greater economic competition for our manufacturers, and we have had to fight to maintain our technological and commercial lead. As U.S. economic growth has slowed from its rapid pace of the 1960's, greater sacrifice has been required to expand our military establishment and project our power and influence around the world. Our dependence on foreign credit in the 1980's has hammered home the sad reality that debtor nations find it hard forcefully to enunciate principles of international conduct to their creditors.

Another factor has been the status of our middle class and poor. Average inflation-adjusted wages have seen virtually no growth since the early 1970's. Family income have grown because of more paid work by married women, rather than because of higher pay per hour of work. We have found the prevalence of homelessness, hunger, and deteriorated neighborhoods to be increasing, and the cost of remedying them to be more burdensome.

The simple mathematics of growth is sobering. If an economy grows at a rate of 2.5 percent per year, the rate projected by many economists for the United States today, its output would be 3.5 times higher after 50 years. However, with 4.0 percent growth, output would be 7.0 times higher. With a 4.0 percent growth rate, the Nation could mount the same defense program with only half the sacifice as a percent of GNP after only one-half century, and its citizens could be more than twice as prosperous after paying for it. Alternatively, if a rival nation's economy grows faster, greater sacrifice will be needed to maintain defense parity.

All of these phenomena have demonstrated that economic growth can determine the well-being of a nation in many dimensions. Prosperity is growth, and world leadership requires growth. Even compassion can be limited by a lack of growth.

But this awareness has not been accompanied by action. Economic policy has ignored many prerequisites of growth, and its large budget deficits have followed the single worst anti-growth path. The result has been an unintended choice of short-term consumption over long term prosperity, of attempting to borrow our way to prosperity. This path has been pleasant, but is is not sustainable. In the long-run interest of the Nation, we must reorient our economic policy toward interest of the Nation, we must reorient our economic policy toward the future. And it is incumbent upon us to begin now before our debt compounds its or economic misfortune ties our hands.

THE ROLE OF THE BUDGET

As this Committee's Report made clear, the Federal budget deficit is primarily a long-term economic issue. The long-term impact of budget deficits, as the 1989 CEA Report acknowledged, is to reduce capital formation. And several of the phenomena cited earlier in these Majority Views contribute to that impact.

The U.S. trade deficit is financed by some reduction in our wealth relative to the rest of the world; the excess of the value of our imports over our exports must be paid for. In recent years, the trade deficit has been financed largely by reducing U.S. purchases of overseas, assets, while foreign purchases of assets in the United States have continued or even grown. This has reduced the continuing flow of net U.S. investment earnings; in other words, it has reduced our income in perpetuity. In 1981, the United States earned about $34 billion in net investment income (the excess of investment income on our assets overseas over the investment income on foreign-owned assets here); that flow has been cut almost to zero, and it will become increasingly negative if our trade deficit continues. As we noted earlier, the U.S. budget deficit is chiefly responsible.

The continuing budget deficits accumulate directly as a larger national debt; as was noted in the Report, the debt has roughly tripled over the decade. That debt must be serviced. For those economists who believe that taxes significantly inhibit work, savings, and investment, the need to collect taxes to pay the interest on the mounting debt must be discouraging. And because the accumulation of the debt over the 1980's produced no discernible increase in investment, as Figure 1 in the Report made clear, the Nation will have no larger income base out of which to extract those necessary taxes.

Counterbalancing the stimulative budget deficits have been restrictive high interest rates. High interest rates have attracted the foreign capital necessary to finance our large deficits, but have also induced purchases of dollars that have driven the dollar's value higher. The high dollar has advantaged imports to the United States and disadvantaged our exports. The resulting squeeze on our producers of tradeable goods has eroded the U.S. manufacturing base, inhibited investment, and destroyed jobs. This has magnified the direct effect of high interest rates on agriculture, housing, and business investment.

Without deficit reduction or an unprecedented increase in U.S. private savings, the Nation will retain the insatiable appetite for foreign credit that it has developed in the 1980's. This will continue to erode our international net wealth position and require investment-inhibiting high interest rates, thus perpetuating the upward pressure on the dollar that guarantees a large trade deficit and capital inflow.

Also, the budget deficit's creation of short-term economic uncertainty detracts from long-term growth. U.S. business needs economic stability. Manufacturers cannot plan to invest for export with a wildly fluctuating dollar which directly affects their overseas prices. The high dollar of the mid-1980's made many manufacturing establishments unprofitable, and manufacturers today hesitate to make large commitments for investment in the fear that another rise in the dollar will quickly render their investments useless.

SOCIAL SECURITY AND LONG-TERM GROWTH

Today's budget deficit, however large, is a deceptively optimistic indicator of our long-term fiscal position. The social security trust fund has run large and growing surpluses since 1983, when revenues were increased and gradual reductions in benefits were enacted. As noted in the Committee's Report, the $37 billion increase in the social security surplus from FY86 to FY89 contributed about half the reduction in the deficit.

The social security surpluses will accumulate as a reserve against the retirement of the "baby-boom" generation in the next century. At that time, the share of the adult population working and paying social security taxes will be much lower than today, and the share receiving social security benefits will be much higher. However, the current buildup in the social security trust fund—representing merely an accumulation of claims against the rest of the Federal Government, which is running even larger budget deficits—will not guarantee the capability to pay those future benefits. To raise cash to pay those benefits, the accumulated bonds will have to be sold on the open market, which will have the same effect on the market as new borrowing.

To increase the Nation's capacity to meet its future social security commitments, we must increase national savings and capital formation. That would make us a wealthier Nation, more able to buy those accumulated bonds in the next century. The surest way to accomplish this is for the Federal Government to reduce its deficit. Meeting the ultimate Gramm-Rudman-Hollings target of a unified budget balance (a balance in the total of social security and all non-social security spending and revenues) would mean only that the non-social security deficit would be cut to the size of the social security surplus (which would still be a major accomplishment). The CBO projects a baseline non-social security deficit for FY93 of $239 billion, and a social security surplus of $103 billion—requiring policy action to reduce the deficit by $136 billion. Such action would eliminate the Federal Government's drag on national savings.

An extremely ambitious goal would be the elimination of the non-social security deficit (as recommended by the National Economic Commission), so that the entire social security surplus would be a net addition to national savings. Achieving this goal by FY93 would require the full $239 billion in deficit reduction, which is surely unrealistic. However, the Nation should choose its long-run goal for the budget once the proximate goal of a zero total deficit is near. At that point, it may or may not seem appropriate to set a new goal for the unified budget of a surplus as large as the social security surplus. The strength of the economy, the level of private savings and investment, the structure of interest rates, and the level of foreign capital inflows—impossible to predict at this time—should influence the decision.

In summary, large budget deficits are the single most anti-growth policy that the Nation could choose; reducing the deficit would be a major contribution to growth.

THE ADMINISTRATION'S BUDGET POLICY

The Economic Forecast.—The economic outlook has become crucial to the budget debate because of its role in judging compliance with the Gramm-Rudman-Hollings deficit reduction requirements. The credibility of the multiyear deficit reduction path is at issue in the eyes of the world's financial markets.

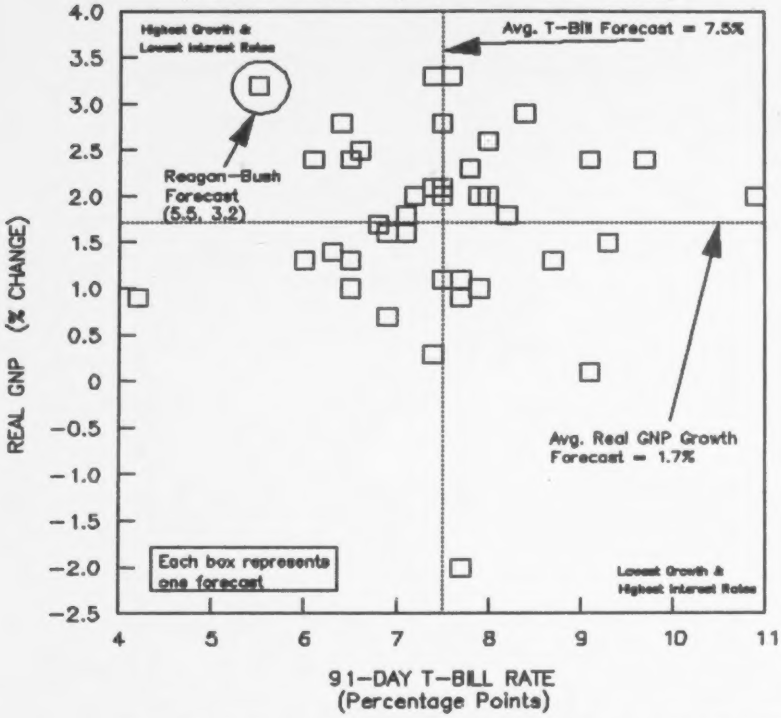
The most important variables in the budget's economic forecast are real economic growth and interest rates. Faster real growth reduces the deficit because it raises incomes and thus increases tax revenues and reduces income-support payments. Lower interest rates also reduce the deficit because they decrease the cost of servicing the growing national debt. If economic assumptions are overly optimistic, the deficit will appear smaller in the short run, and even more so in the years ahead. Belittling the need for deficit reduction now by making optimistic economic assumptions will leave spending and revenues further out of balance in the future; it will also expand the national debt, increasing interest charges in later years. If experience is any guide, the prudent course is to adopt a cautious, not an optimistic, economic outlook; assuming faster economic growth is not likely to make it happen.

In preparing its budget projections for the next five years, however, the Administration accepted from the outgoing economic policy team a more favorable combination of growth and interest rates than any major private forecast. Administration economists have pointed out that several private forecasts call for comparable growth rates, and that several anticipate comparable interest rates. However, in a survey of 39 major private forecasters, the two private forecasts of stronger growth than the Administration's predict interest rates two percentage points higher, and the only forecast of lower interest rates assumes real economic growth two percentage points lower (see Figure 9).

FIGURE 9

REAGAN/BUSH & PRIVATE ECONOMIC FORECASTS FOR 1990

(REAL GNP GROWTH/91-DAY T-BILL RATES)



SOURCE: OMB and Blue Chip Economic Indicators (2/10/89)

The Administration's optimism applies not only to next year but to succeeding years as well. It implies that we can "grow out of the deficit" with a relatively painless freeze on real spending at last year's levels. But if the forecast proves even modestly optimistic, reaching the Gramm-Rudman-Hollings goal of a balanced budget by FY93 will be much more difficult. For example, if real growth averages 2.5 percent instead of the projected 3.2 percent, the deficit will be $17 billion larger in FY90 and $71 billion larger in FY93 (based on CBO estimates). If interest rates are one point higher, the deficit will be increased by $11 billion in FY90 and $24 billion in FY93. The unavoidable conclusion is that we must have realistic economic assumptions for effective budgeting.

Priorities.—It is difficult to assess the relative priorities assigned to different Federal activities in the Administration's budget. At a very technical level, the Administration's budget documents for FY 90 are written in terms of outlays but include no figures for specific appropriations, the basis on which Congress must decide spending policy. In fact, the budget does not provide separate figures for most domestic discretionary programs, but instead lumps them in a single outlay amount.

At a broader level, a number of vital decisions are simply not made. The Administration recommends that total domestic spending be limited to $22 billion less than the OMB inflation-adjusted budget baseline. Some domestic programs are subjected to specific cuts from the current level of services ($5 billion in Medicare, $4.7 billion in Federal employee pensions, and $1.9 billion in farm programs, for a total of nearly $12 billion). But most domestic discretionary programs have been placed in what has been termed a "black box," and subjected to a "freeze" defined as spending in FY90 the same nominal amount ($136 billion) as now projected for FY89. This would mean an additional $10 billion in inflation-adjusted cuts. However, the Administration does not specify an exact amount of spending for each program, reducing the credibility and the potential effect on financial markets of the stated intention of reducing the deficit.

Also troubling is an apparent departure of word from deed in the expression of budgetary priorities. In his speech before a Joint Session of Congress on February 9, the President expressed his agreement with the long-standing position of Democrats that government must address more adequately the serious problems in education and the environment. Although the budget has singled out narrow programs affecting education and the environment for some small increases, most spending in those two areas falls into the "black box" of programs slated for no increase in outlays (and significant cuts in budget authority) from FY89 to FY90. Education programs in the "black box" include compensatory education, vocational education, education for the handicapped, and college student financial aid. The "black box" also contains such environmental programs as the "Superfund" program for cleanup of hazardous waste, Environmental Protection Agency (EPA) enforcement and research, construction grants for sewage treatment plants, soil conservation programs, and national parks and forests. Because it is growing and has long lead times, the Superfund could have a $1.5 billion (83 percent) cut in new budget authority.

Echoes of 1981.—The current budget message has two disturbing echoes of the 1981 budget message—large but unspecified cuts in domestic programs and the promise of more revenues with cuts in tax rates. The "black box" is reminiscent of the "magic asterisk" used in the 1981 budget proposals to indicate unspecified future spending cuts. This year's projection of $5 billion in additional revenues with a 45 percent cut in tax rates on capital gains also recalls the long-since discredited 1981 projection that across-the-board cuts in income tax rates would raise revenues.

Conclusions.—All parties, including the President, recognize the need for budget action to safeguard the economic expansion and to augment long-term growth. For that reason, the new Administration's economic policy initiatives have been disappointing. They do not advance a deficit reduction effort that has fallen short thus far.

The use of optimistic economic assumptions and clever budget tricks has allowed the Gramm-Rudman-Hollings deficit reduction targets to be met each year without meaningful deficit reduction. In fact, Gramm-Rudman-Hollings has nothing to do with reducing the deficit; it requires only that we reduce the projected deficit. Apart from fiscal 1987, when extreme accounting tricks were employed, the actual budget deficit has never been within $10 billion of the Gramm-Rudman-Hollings targets. In the last two fiscal years, the deficit has increased even though the Gramm-Rudman-Hollings requirements were met. If the budget were on the original Gramm-Rudman-Hollings timetable, the deficit for FY90 would be $36 billion; instead, the CBO baseline places it about $100 billion above that level, despite a recent economic performance that has exceeded our expectations.

A fundamental first step for deficit reduction must be a prudent economic forecast. Optimistic economic assumptions can reduce the scale of the problem to a level that is solvable for a single year with only accounting gimmicks, which merely postpone the deficit bill with interest. If this game is not ended before the onset of a recession or an external economic shock, the Nation will find itself unable to use its policy tools freely. In contrast, realistic economic assumptions would make the scale of the deficit problem clear, and help to stimulate meaningful deficit-reduction policy steps.

Under the new Gramm-Rudman-Hollings rules, the development of the economic forecast is solely in the hands of the Administration. Here, as in so many other areas of budget policy, presidential leadership is essential. However, the current budget's reliance on an optimistic economic forecast strains the new Administration's credibility, and understates the need for action; the assumption of additional supply-side tax revenues probably increases this sense of complacency . If action is postponed, long-term growth will be reduced and short-term stability could be lost.

Furthermore, we believe that a realistic and prudent budget that reveals the true scope of the deficit problem will make clear the need for compromise. The Administration's proposal suggests that the deficit problem can be postponed for one more year while protecting defense spending and providing only minimal new revenues. Even in these terms, the budget would almost certainly shrink budget authority for education, training, the environment, and other domestic problem areas. On the basis of more realistic economic assumptions, however, it would be clear that the Administration's approach could not help but starve domestic priorities that have broad bipartisan support, such as those cited in this Committee's Report.

We need to put our fiscal house in order; the deficit is hurting the country. The American people understand that the Nation cannot indefinitely live beyond its means, consuming more than it produces. Even though the necessary steps will be painful, the people will accept an honest and realistic approach to solving the deficit problem.

POLICY PRIORITIES FOR THE LONG TERM

Beyond deficit reduction, there are other policy initiatives identified in the Report that would advance the long-term health of the U.S. economy. These priorities have been neglected to an unfortunate degree. We believe that the environment, infrastructure, and R&D merit perhaps even greater priority and a more prominent

Federal role than was suggested in the Report, with special attention due to ground, water, and air transportation improvements for greater capacity and safety, and to nondefense basic and applied R&D. We believe that education has been shortchanged in the Administration's budget proposals, as discussed below. We also believe that energy policy and financial fragility deserve greater attention.

Education.—The Report identified education as a priority issue to both Republicans and Democrats. However, we believe that education deserves more resources and a more explicit Federal commitment than the Administration has allowed.

Education is primarily a State and local government function. States and localities are unquestionably exerting enormous effort in education and in a broad range of othr functions; the combined State and local tax burden is now higher than it was at the time of the tax revolt of the late 1970's. However, we believe that localities and even States have varying abilities to support education, and that the Federal Government can play the key role in putting resources where they are needed by targeting weaknesses in educational performance and ensuring equal access to educational opportunity.

A skilled work force is a prerequisite for long-term economic growth, as much as a large capital stock. Forecasts project shortages of skilled labor in the coming decades. The work force of the next century must be educated now; delay will be felt in reduced economic performance for years to come. One logical way to upgrade our work force is to help where educational performance is inadequate, and this is precisely the Federal role. Inner-city and rural schools have the greatest dropout rates, the most difficulty in attracting teachers, and the least resources. Another sore spot is training of dropouts and disadvantaged workers, who are also geographically concentrated, raising again the issue of equal access and opportunity as the Federal role. And yet, over the 1980's Federal expenditures for elementary, secondary, and vocational education failed to keep up with inflation; and spending on training was cut almost in half in nominal dollars.

President Bush has proposed spending an additional $1.1 billion on new initiatives that, broadly speaking, improve education. While it appears that this $1.1 billion is additional funding, the Administration's budget places all other education programs in the "black box" of programs subject to generic cuts. If education takes its proportionate share of these cuts, spending on education will probably decline.

Among the programs in the "black box" are those of the School Improvement Act (the Hawkins-Stafford Act), which are in place and proven effective. Other effective educational programs, including Head Start and Chapter I, do not come close to reaching their entire eligible populations. The importance of these programs to long-term economic growth warrants priority attention in the budget process. The budget calls for increased choice in selecting schools through expansion of the magnet school program. This program was designed as a desegregation tool, and any use must not undermine the desegregation purpose:

Education must be viewed comprehensively to include early childhood development and health; vocational education; dropout reduction; and drug and alcohol prevention. All of these are budget priorities to improve our Nation's educational and economic performance. Laying a sound foundation for economic growth through education can obviate the need for income support, remedial training, and anti-crime programs later.

Energy.—The Nation's economic prospects, in both the long term and the short term, are at risk from our rising dependence on insecure imported oil. The Congressional Research Service estimates that domestic production this year will be the lowest in nearly a generation. This decline has been moderated by rising Alaskan output, but production at the North Slope's giant Prudhoe Bay field, which provides three-quarters of Alaska's output, began an irreversible decline last fall. The years of rising Alaskan output are over, and the decline in total domestic production will accelerate.

While U.S. petroleum supply has deteriorated, demand has grown. Consumption last year exceeded the 1981 level by 7 percent, and energy consumption per dollar of real GNP rose for the first time since 1976. A sizable portion of this increased demand reflects the Reagan Administration's 70 percent cut in energy efficiency programs. Also troublesome are 80 percent cuts in renewable energy R&D.

Oil imports have always filled the gap between demand and supply. Imports last year exceeded 40 percent of consumption, up from 27 percent in 1981, contributing to a 30 percent rate of increase of the PPI over the winter and a $42 billion imported oil bill. And nearly seven of every ten new barrels of oil imported by the United States over this period have been insecure Arab oil.

Despite these developments, the Reagan Administration impounded funds for and deferred expansion of the Strategic Petroleum Reserve (SPR), and the new Administration's first budget postponed the Congress' goal of 750 million barrels by 1993. The SPR should be filled before another supply interruption. For the longer term, the Nation must consider increased use of natural gas and renewable energy sources such as methanol fuels and photovoltaics. We must also increase conservation efforts, including energy efficiency standards.

Financial Fragility.—The economy cannot grow without sound financial institutions. The cost of shoring up insolvent S&L's will differ over the long term depending on the means of finance chosen. The rash of corporate restructuring also has long-term implications; heavily indebted corporations may be unwilling or unable to undertake the investment needed to sustain increased productivity. A recent National Science Foundation study found that companies being taken over, or in the process of resisting a takeover, cut RF&D spending by almost 13 percent, compared to a rise of 5.4 percent in R&D spending in other major corporations.

V. A TWO-TIERED ECONOMY

We believe that U.S. standards of living have suffered in two separate respects not specified in the Report: first, the growth of wages and household incomes has slowed; and, second, the distribution of income has become less equal.

After rapid increases in the 1950's and the 1960's, U.S. wage growth slowed dramatically in the early 1970's. In fact, since 1973, average real wages have been virtually stagnant, and even total compensation (which includes rapidly rising fringe benefits for health insurance) has slowed significantly. At least two possible explanations have been offered. The first is that the energy crisis disrupted the U.S. economy by rendering many existing factories and machines obsolete; this hypothesis has been difficult to prove using economic data. The second explanation is that the large number of young "baby-boom" workers who entered the labor force starting in the late 1960's, along with the many married women who joined or reentered the labor force after spending time raising families, competed with each other for entry-level jobs and bid wages down. This hypothesis will require years of observation to verify.

Whatever its ultimate cause, the slow growth of wages arose directly from the sluggish pace of productivity. After rapid growth in the 1950's and 1960's, productivity was essentially stagnant in the 1970's and has recoverd only partially in the 1980's; and as the current expansion has aged, productivity growth has slowed, in the pattern of every recent recovery. Family incomes mirror wage progress because they consist mostly of wage income, and so the median real family income has grown very little over the last 15 years. And most of that growth was caused not by greater incomes per worker, but rather by more workers per family, as wives entered the paid labor force in growing numbers.

GROWING INCOME INEQUALITY

Over the same period and perhaps for the same reasons, the U.S. income distribution has become significantly more unequal. From recording the greatest degree of income equality in 1969, the official Census Bureau statistics now show the greatest gap between rich and poor since the statistical series began in the late 1940's. While there are many important questions of methodology, including the treatment of both in-kind income (such as government- or employer-provided medical insurance) and taxes, there is no question that the trend of the income distribution has been unfavorable. For example, official Census Bureau statistics show that poverty would have grown faster over the 1980's if in-kind government benefits were counted as income; and the CBO has found that the tax burden has become significantly more regressive since the late 1970's.

THE POLICIES OF THE 1980'S

The problems of slow income growth and increasing inequality have continued over a decade and a half, through four Administrations representing both political parties. While they cannot be assigned to any one President or to any single set of policies, the policies of the 1980's clearly provided no cure, and in at least two respects made matters worse.

There was no policy breakthrough in this decade. Though unemployment has declined, wages have remained sluggish and the trend toward inequality has continued. Productivity grew rapidly in the early stages of the recovery, as it does in most business cycles, but then slowed. The slow growth of wages in the 1980's might be seen as a price that must be paid for the creation of new jobs and a consequent widening of economic opportunity; but the policies of the late 1970's created more jobs per year than those of the 1980's, with equivalent real wage performance.

Moreover, some policies of this decade did aggravate inequality and wage sluggishness. The cutbacks of human resource programs in the early 1980's, especially Aid to Families with Dependent Children, Medicaid, and food stamps for working poor and near-poor families, clearly increased inequality. Reduced resources for education and training sowed the seeds of increased inequality and slower productivity growth for years to come. And the extreme fiscal and monetary policies that drove the dollar higher also forced many manufacturing firms to close or cut back on employment, thereby destroying large numbers of high-paying jobs. We cannot ignore growing inequality or lapse into self-congratulation while real wages continue stagnant.

POLICY CHOICES

Over the past eight years, several important policy problems have worsened, and some programs have received insufficient attention.

Poverty and Health Care.—As stated in the Report, the Nation faces the enormous challenge of providing an equal life chance to every child born in the United States. Part of this challenge is in education, which has been described above. But as suggested in that discussion, the advancement of opportunity is a multidimensional task. Further, because poverty is often geographically concentrated, we believe that Federal initiative and funding are required to put resources where State and local governments have the least resources of their own.

The poverty rate is higher now than it was at the peak of the 1974–75 recession. There were 32.5 million poor in 1987, up from 29.3 million in 1980. To reduce poverty, continued growth of job opportunities is essential. About 15 percent of this Nation's poor families are headed by a full-time, full-year worker, so the resumption of wage growth, stalled since the early 1970's, is clearly necessary. Worker training programs can expand opportunity and reward short-term investments with long-term dividends in the form of reduced income support and anti-crime program costs.

Health care needs must not be ignored. Many children on the border of poverty have no health insurance protection, and lack the preventive care necessary for learning and personal growth. The cost of covering the uninsured would be very high,so we must think and innovate. But the cost should not distract us from the priority that health care deserves.

America today is a land of opportunity for most of us, but a land of hopelessness for some. Many Americans are concentrated in decaying urban neighborhoods or isolated in rural areas with little prospect of advancement. The absence of opportunity and visible role models for chidren, the dearth of decent housing and schools, and the prevalence of crime and drug abuse in these areas make this a multidimensional problem. This problem will only be resolved when considerable additional resources, beyond those generated within these same areas of economic stagnation, become available.

Housing and Homelessness.—Today, many would-be first-time home buyers cannot afford to break into the housing market; and for most Americans, home ownership still provides the greatest opportunity to accumulate wealth. New home construction slowed from 1.76 million starts per year in the 1970's to 1.51 million starts per year in the 1980's tightening the market and raising prices. After decades of steady increases, the percentage of persons who own homes declined in the 1980's, largely due to a sharp drop among those under 35 years of age. Rents have also escalated with the general rise in housing prices, making accumulation of a down payment even more difficult. These rising prices have trickled down the market to contribute to our growing homelessness problem.

Record high real interest rates are a major roadblock to affordability. And the major contributor to high real interest rates is the enormous volume of credit needed by the Federal Government to finance its deficit. High home finance costs—as well as high costs for automobile and other household credit—are a heavy and selective tax on the U.S. population. Reducing that tax will require shrinking and ultimately eliminating the shortfall of Federal Government revenues relative to expenditures. And if the Nation does spend about $100 billion to restore the losses of S&L's, it should, in the process, revitalize the home finance function that was the original rationale of the S&L industry.

The appalling number of homeless Americans is one measure of our housing problem. The supply of subsidized low-income housing is at risk because of the upcoming end of the contract terms of most Section 8 low-income housing units. Expanding the stock of low-income housing would require the reversal of the policies of the preceding Administration that cut Federal outlays more than 90 percent, from about $10 billion to about $1 billion. Housing vouchers could be constructive in theory, but any program that covered the poverty population would be far more expensive than the current effort, which serves only 6 percent of the poor. Initiatives to aid today's homeless must extend beyond housing to job training and placement and medical care.

Rural Development.—One-quarter of America's population still lives outside our major cities, and the rural economy is changing. Fewer than one-quarter of the nonmetropolitan counties are primarily dependent on agriculture, and they include only 7 percent of the rural population. By contrast, manufacturing is the dominant activity in another quarter of our rural counties, and they include 32 percent of the nonmetropolitan population. And while stabilizing American agriculture has been a major economic policy objective for much of this decade, even nonfarm rural America has not recovered from the 1981–82 recession. Rural unemployment and poverty rates remain well above urban rates, rural incomes have fallen further behind urban incomes, and out-migration from rural areas has increased.

It is in the Nation's interest to bring rural America into the economic mainstream. A rural labor force with increased skills could forestall a forecast national shortage of skilled labor. While the Federal Government cannot induce growth, rural areas need help to support economic growth. This involves adequate infrastructure, including schools, roads, hospitals, and sewer and water systems, all of which must meet current technological and environmental standards. The EPA estimates that it will cost $20 billion to bring rural areas into compliance with the Clean Water Act. Many of these communities lack the fiscal capacity to meet these and other infrastructure needs.

Availability of credit is a central issue for rural governments and businesses. Rural communities face higher costs in bond markets because their small and infrequent borrowing increases transaction costs. Small rural businesses face similar problems. Federal Government efforts to pool or spread risk and increase liquidity in rural areas would help rural small business to grow, and rural governments to finance needed infrastructure.

During the previous Administration, rural areas suffered severely both from the dismantling of Federal assistance to rural infrastructure and human services, and from counterproductive macroeconomic policies. High interest rates and unfavorable exchange rates crippled tradeable goods industries—such as agriculture, manufacturing, mining, and forestry—that are vital to rural areas. While these industries have partially recovered, they have lost export and domestic markets and now face entrenched competition from foreign enterprises. Recent increases in interest rates will further hinder the slow rural recovery. A stable macroeconomic environment is essential to rural America.

VI. Conclusion: A Window of Opportunity

The Nation faces two imperatives. First, we must maintain, and ultimately increase, our rate of economic growth; and, second, we must give all Americans the opportunity to share in that growth. The Democratic Members of this Committee believe that we need new economic policies to achieve these goals.

We approach the 1990's with a sustained, but not a vigorous, economic expansion, and with a base of declining unemployment and moderate inflation. However, the policies that brought us to this point clearly are ill-suited for the future. These policies have created serious economic imbalances that could easily breed accelerating inflation, a continuing trade imbalance or failing financial institutions, and thereby end the expansion. And current economic policies leave us with no flexibility to deal with these or any other economic shocks. So our short-run path involves serious risks that the current recovery does not dispel.

Furthermore, these same policies reduce our long-term growth by inhibiting investment and eroding our Nation's holdings of wealth. The rapid growth of our national debt and the decline of our international investment position are telling indicators of this reduction in our long-run prospects, which will continue to worsen until our policies are revised.

The relatively favorable position of the economic indicators today presents us with a window of opportunity. There is a new President, and a new Congress. We have a populace that appreciates the importance of economic growth, and realizes that our current large budget deficit is dangerous for us and imprudent for the prosperity of our children and their children. We all realize that we must correct our policy imbalances before the economy is tested by any misfortune, and that we cannot safely plan only for the best case.

Now, while economic growth continues, the Nation has the luxury of looking to the future and shaping policies to promote growth and fairness. If we procrastinate, we may lose that luxury.

ADDITIONAL VIEWS OF REPRESENTATIVE AUGUSTUS F. HAWKINS

I congratulate and commend Chairman Hamilton, the JEC staff, and the other Members of the Committee for producing a comprehensive assessment of the state of the U.S. economy. While I do not agree with all views expressed in the Annual Report and Majority Views, I believe their support for promoting economic growth, and the Majority Views' excellent analysis of current policy, provide useful contributions to our ongoing economic decisionmaking process.

I believe, however, both reports could have been strengthened by the inclusion of more specific policy and programmatic recommendations. The Joint Economic Committee (JEC) should stress the importance of implementing a more coordinated economic policy through the use of goal-setting procedures. The Employment Act of 1946, as amended by the Full Employment and Balanced Growth Act of 1978, establishes a goal-setting procedure for recommending policy priorities, and sets timetables for achievement of the goals in order to hold policymakers accountable for their decisions.

I continue to believe the JEC can and shoud play an active role in determining Federal budget priorities and long-term economic policy. The procedure of merely indicating the projected results of current policy fails to achieve needed changes. The Committee should forthrightly set goals for the achievement of full employment and price stability, and then programatically show how those goals can be reached through changes in budget and fiscal priorities.

Such actions would be a catalyst for the much-needed broadening of current economic policy deliberations.

AUGUSTUS F. HAWKINS.

ADDITIONAL VIEWS OF SENATOR PAUL S. SARBANES

I am concerned that the Report conveys an inappropriate sense of complacency with regard to our current economic situation. What it calls "uncertainties" are in fact severe weaknesses in the economic fabric of this country. This distinction is more than semantic: economic weakness implies the need for prompt remedial action, uncertainty allows us to postpone any redirection of policy. I believe we face economic weaknesses of such magnitude as to warrant remedial action.

Over the past decade, we have created unprecedented imbalances—in the budget, in international trade, in the accumulation of both domestic and international debt—which suggest that the economy is skating on very thin ice. While there may indeed be uncertainty about where and when the ice will crack, we stand a better chance of avoiding the cracks if we acknowledge forthrightly the nature of our current economic situation.

Many of these weaknesses stem from past policy errors which have been only partially corrected. Despite recent small improvements, the United States still runs a huge trade deficit. This descent into deficit was accelerated dramatically during the 1980's by policies which largely ignored the root causes of our trade deterioration—misaligned exchange rates, domestic macroeconomic imbalances, foreign limits on market access, and deteriorating competitiveness among American industries.

Subsequent reversals of some of these policies—particularly misaligned exchange rates—led in 1986 and 1987 to a decline in the dollar and a temporary boom in exports. This boom appears to have stalled after the middle of 1988, while imports have continued to trend upward. Extrapolating the trends of the past nine months leads to the conclusion that our present course will produce little further reduction in our trade deficit over the next decade. Such a course is clearly unsustainable, and a more decisive change of direction is clearly called for.

The continuation of large merchandise trade deficits is of particular concern for the future because past deficits have undermined our former status as a creditor country. In recent years, the United States has experienced an historically unprecedented (and still continuing) slide from creditor to debtor nation. Our substantial and growing net interest payments to foreign investors now must be added to our merchandise trade deficit to determine how much we must borrow from abroad each year. Each year's new borrowings add to our external debt obligations, creating a burdensome "Legacy of Debt" which we pass on to the next generation.

This legacy not only undermines future prosperity—through large interest payments to our international creditors—it also weakens our international influence and provides a dangerous element of instability in the economic outlook. Our continued dependence on large foreign borrowings makes our interest rates vulnerable to the decisions of foreign investors and threatens the stability of the dollar on foreign exchange markets.

Inappropriate policies have also encouraged a dangerous accumulation of debt in the domestic economy. Highly leveraged corporations are much more vulnerable to an economic slowdown than those more prudently capitalized, and a vulnerable corporate sector increases the already serious concern about the state of our financial institutions. Sweeping deregulation of capital markets in the 1980's has already produced one major policy disaster—the massive failures in the Savings and Loan industry—and there are serious grounds for concern that excessive debt accumulation may be laying the groundwork for other financial crises in the years ahead.

One such crisis is clearly upon us. The recent riots in Venezuela underscore the failure of existing international debt policy to resolve the conflicts which are undermining fragile democratic governments in the debtor countries. Even those countries which have made major strides in economic policy reform have not seen their efforts rewarded by improved flows of funds from their creditors. A change of course in international debt policy is urgently needed, a fact recognized by Secretary Brady's recent endorsement of debt reduction.

On the domestic front, policy over the past decade has clearly failed to maintain adequate funding for housing, education, infrastructure, research, environmental quality and a number of other critical public investments. These investment deficits are catching up with us, and are threatening the future strength and vigor of the economy.

The present recovery has been long-lived, but longevity is not necessarily a good indicator of success. Income has grown more slowly in the 1980's than in previous periods. Further, it has been distributed far more inequitably, resulting in an undermining of the middle class. Net investment has also grown more slowly than in the past, creating capacity constraints in many industries and contributing to our disappointing performance in productivity. Inflation was tamed early in the decade, but at the price of the deepest downturn since the Great Depression. Recent signs of renewed inflation suggest that the substantial sacrifice made by American workers during the 1981–82 recession may not have produced a lasting victory against this problem.

The economic problems outlined above clearly require our attention if we are to assure the health and vitality of our economy. We do ourselves and our children a great disservice if we fail to recognize these problems and take steps to correct them.

PAUL SARBANES.

ADDITIONAL VIEWS OF SENATOR LLOYD M. BENTSEN

I want to congratulate Chairman Lee Hamilton and the Committee staff for preparing the Joint Economic Committee's innovative 1989 Report as well as the thoughtful and comprehensive Majority Views. Prospects for real income growth are hampered by the underinvestment plaguing our economy. We face severe challenges in reversing course to boost investment. And Majority Views in this Report provide an excellent perspective on those challenges, including the urgent need to eliminate the budget and trade defícts. I believe the roots of the budget deficit remain excessive spending, and that is where deficit reduction efforts must be focused. At the same time, prudence demands that defense spending for the time being keep pace with inflation.

I do not believe that a lower dollar is necessary to boost U.S. exports. Lower trade barriers abroad would do that. As the Majority Views notes, the U.S. merchandise trade deficit is predicted to resume deteriorating this year, exacerbating our dependence on foreign capital and causing U.S. foreign debt to balloon beyond $600 billion. That will sharpen the risk of financial instability, with Treasury Secretary Brady, for one, attributing the 1987 Black Monday stock market collapse to skittish foreign investors concerned with a lackluster U.S. trade performance.

Eliminating the foreign debt drag on real income growth hinges on eliminating the U.S. trade deficit and mirror-image trade surpluses in our trading partners. Eliminating the budget deficit is part of the answer. But the United States cannot unilaterally eliminate world trade imbalances. As the Majority Views notes, trade surplus nations like Japan and Germany must ease protectionist barriers to U.S. exports as well.

LLOYD BENTSEN.

ADDITIONAL VIEWS OF SENATOR JEFF BINGAMAN

I commend Chairman Hamilton and the staff of the Joint Economic Committee for producing this valuable report on the American economy. While I agree with most of the Joint Economic Report, I am concerned that it paints an overly rosy picture of our economy over the past decade. It is true that GNP growth has continued for over six and a half years—an economic expansion third only in length behind the World War II expansion of 1938 to 1944 and the remarkable economic growth of the decade of the 1960's. But this expansion has been fueled by a massive budget deficit which has resulted in a $1.2 trillion increase in the Federal debt over the past eight years and has been accompanied by historically large trade deficits and the slippage of the United States from a creditor nation to the world's largest debtor nation.

It is also true that unemployment has recently dropped to levels not seen since the early 1970's. But workers' real wages continue to grow slowly after stagnating for most of the decade to the point where it takes two-wage earners in many families simply to maintain their standard of living, inequities in income and wealth seem to be growing, the rate of homeownership has declined, and the personal savings rate plummeted. This is not a picture of a healthy and successful economy, but of a very vulnerable one.

I strongly agree with the Report as to the challenges facing the economy: the need to ensure future economic growth and stability combined with opportunities and fairness. However, I believe that the challenges we face are the direct result of the failure of economic policy over the past decade. As the Majority Views point out, we have failed to provide for the future and we need a new economic policy. I would like to emphasize this point. Our task, I believe, is not one of building upon our supposed success, but of correcting the efforts of the past—errors which may have resulted in short-term gain but have sown the seeds of long-run difficulties. We must reverse these past mistakes and put our economic house back in order.

JEFF BINGAMAN.

MINORITY VIEWS

PREFACE

Republican Members of the Joint Economic Committee (JEC), during the depths of the 1981–82 recession, wrote in their 1982 Annual Report:

> The Republican Members * * * are optimistic about the prospects for the national economy in 1982. We believe in the fundamental soundness of the Reagan economic program and are confident in its success. We reject calls for a change in direction, for tax increases, or a return to the worn-out Keynesian economic policies which got us into the current economic mess. We recommend continuation and enhancement of the program which is already in place.

Republican reports from 1983 through 1987 continued strong endorsements of Reagan economic policies, Last year, Republican Members of the Committee concluded:

> The economy is now well into its sixth year of expansion, the longest peacetime expansion in our history. Inflation is under control and investment is strong. The economy has spawned four million new businesses since 1981 and has shrugged off Black Monday. Most importantly, the economy has generated 15 million new job, and real merdian family income has climbed 10.7 percent since 1982. The foundation of any economy is a people at productive work. Never has the foundation of our economy been stronger.

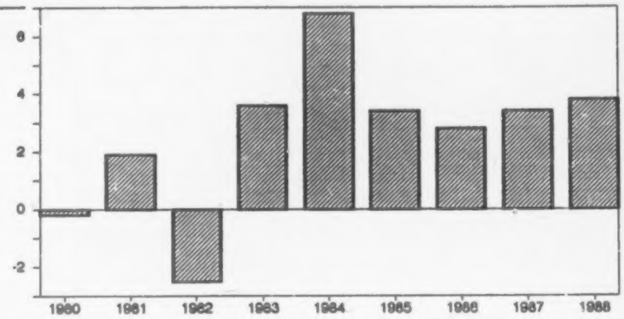
The 1981 tax legislation laid the foundation for the current expansion. This measure, the Economic Recovery Tax Act of 1981 (ERTA), cut personal tax rates 23 percent across the board and indexed tax brackets for inflation. By reducing the tax barriers to the flow of resources into production, advocates claimed that economic growth without increased inflation would be the result. As the Reagan expansion strengthened, the U.S. economy led the world out of recession, and tax rate cuts were emulated by governments around the globe.

Now in its seventh year, with virtually every major economic forecasting firm predicting continued growth in real GNP for both 1989 and 1990, the expansion has taken on the attributes of a well-trained long-distance runner. If properly nourished and unburdened, it can reach truly great lengths.

In a sense, during the last eight years, the economy has seen the best and worst of times. After the worst recession since the great depression, the economy is now going strong in a record-setting expansion. The following is a brief statistical review of the performance of five key economic indicators: real growth in gross national product (GNP), unemployment, inflation, interest rates and investment.

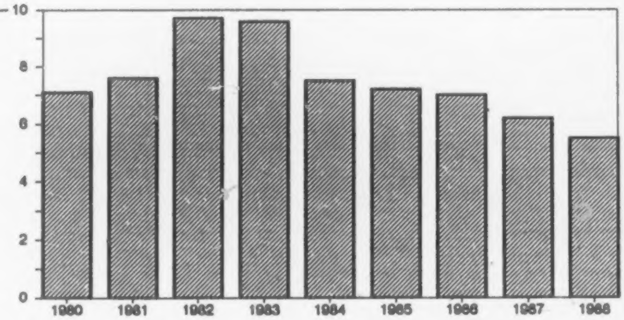
REAL GNP GROWTH

Year	Percent Change from Previous Year
1980	-0.2%
1981	1.9
1982	-2.5
1983	3.6
1984	6.8
1985	3.4
1986	2.8
1987	3.4
1988	3.8



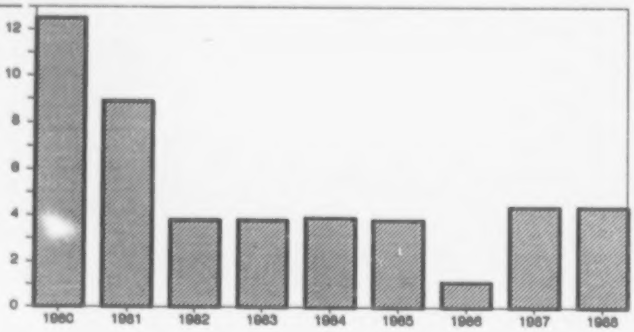
UNEMPLOYMENT

Year	Unemployment for Civilian Workers
1980	7.1%
1981	7.6
1982	9.7
1983	9.6
1984	7.5
1985	7.2
1986	7.0
1987	6.2
1988	5.5



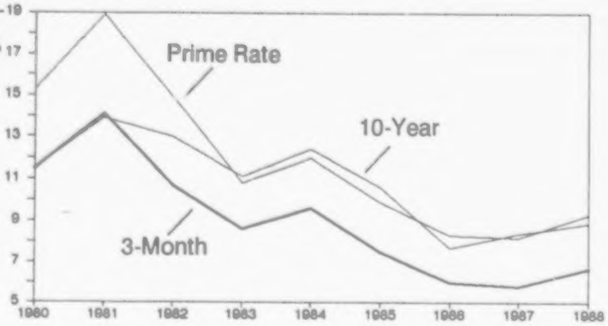
INFLATION, as measured by the Consumer Price Index

Year	Annual Percent Change In the CPI-U
1980	12.5%
1981	8.9
1982	3.8
1983	3.8
1984	3.9
1985	3.8
1986	1.1
1987	4.4
1988	4.4



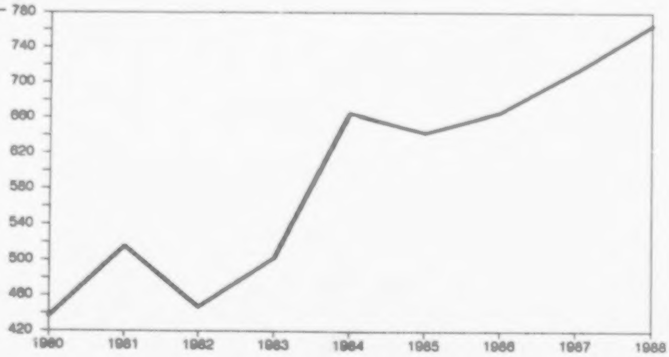
INTEREST RATES

Year	3-Month T-Bills	10-Year Constant Maturity	Prime Rate
1980	11.5%	11.5%	15.3%
1981	14.0	13.9	18.9
1982	10.7	13.0	14.9
1983	8.6	11.1	10.8
1984	9.6	12.4	12.0
1985	7.5	10.6	9.9
1986	6.0	7.7	8.3
1987	5.8	8.4	8.2
1988	6.7	8.9	9.3



GROSS PRIVATE DOMESTIC INVESTMENT

Year	$Billions
1980	$437.0
1981	515.5
1982	447.3
1983	502.3
1984	664.8
1985	643.1
1986	665.9
1987	712.9
1988	766.1



We cannot emphasize enough the importance of the connection between free and fair world trade and U.S. economic growth. Last year's Republican report described exports as this Nation's next growth sector. And indeed our exports of goods and services grew by better than $90 billion during 1988, the largest annual increase in history. But there's much more to trade than just numbers and prosperity. Our economic success is intertwined with our principles of democracy. America's unique version of democratic capitalism is not just known, it is envied, around the globe.

Today, experimentation with the free market is taking place throughout the world, notably the Pacific Rim and even such unlikely places as China and the Soviet Union. As a result, the economic gap between the United States and developing—as well as developed—countries is narrowing. Indeed, this evolution toward competitive economies has changed the fundamental structure of the world economy and the relationship of the United States to it. If we are to take full advantage of this new global economic opportunity, we must appreciate, understand, and actively continue to mold it. In this vein, we repeat here what we said in our 1985 report:

> The key to achieving a generation of growth is the implementation of Federal policies which foster the long-term competitiveness of or economic system. As a general guideline, U.S. economic competitiveness will be enhanced by Federal policies which reduce Federal spending, taxation, and regulation, and raise private-sector savings, investment, and self-reliance. This policy guideline must be coupled with a stable monetary policy which will accommodate growth. Competitiveness is a market phenomenon, and cannot be centrally planned, managed or legislated.

The Minority Views of the Republican Members of the JEC will discuss the past progress made under Reagan Administration economic policies and described how we are well-positioned for continued success. The Minority Views will concentrate on the following areas: America's rising standard of living, the Federal budget, the changing international economy, and the economic implications of demographic change. Our conclusion is not surprising: Predictable, stable, and incentive-based policies reversed the disastrous economic trends of the late 1970s and set us on a course leading to the longest peacetime expansion in U.S. history. The market, supported by such policies, is a problem solver. If only government spending could be subject more directly to such market-oriented policies, that challenge, too, would then be resolved.

I. ECONOMIC PROSPECTS

The current expansion has experienced and overcome a number of shocks during its long life—an historic stock market crash, military tensions around the globe, growing budget and trade deficits, significant tax reforms, and drought. Yet the expansion rolls on, as if guided by some natural physical law whereby an economy, once placed in motion by market-oriented and stimulating policies, tends to stay in motion. If Federal fiscal, monetary, regulatory, and intentional trade policies continue to be stable and incentive-based, the expansion will continue. An increasingly popular adage deserves repeating, namely, that expansions don't die from old age but from bad economic policies.

POLICIES OF PROSPERITY

Hoping that we've learned our lessons well, we offer steady and sound macroeconomic policy considerations for 1989. Given the soundness of the economy demonstrated by job growth, GNP increases, and the resilience of financial markets following the 1987 crash, we see no cause or justification for a significant change in establishing and proven economic policy.

Fiscal policy

Prior to the Reagan Administration, fiscal policy was often used as a tool to smooth aggregate demand and otherwise to "fine tune" the economy. Federal government attempts to stimulate or dampen consumption, investment, and government spending were often counterproductive and contributed to variability in aggregate demand. Frequent and unanticipated changes in taxation policies exacerbated the problem.

An important part of the Reagan economic policy legacy is the demonstrated value of a long-term commitment to a predictable fiscal policy: From the day Ronald Reagan took office to the day he left, his unwavering commitment was to reduce marginal tax rates on personal income and capital, eliminate tax loopholes, and control government spending and regulation. The incoming Bush Administration has proclaimed its acceptance, adoption, and continuation of this legacy. Stable tax rates and a further reduction in the aggregate growth in Federal spending, coupled with anticipated new Federal revenues generated from economic growth in FY 1990—over $80 billion—should be sufficient to achieve Gramm-Rudman-Hollings deficit targets for 1990.

Monetary policy

Perhaps the most significant economic accomplishment of the Reagan Administration was the achievement and maintenance of a modest rate of inflation. The money-growth policy of the Federal Reserve System complemented the Reagan Administration's economic policies and broke the inflationary psychology established during the late 1970s.

The Federal Reserve has, however, demonstrated a tendency during the last several years to abandon its announced growth target policy and react—sometimes overreact—to short-term erratic developments in the real economy. As with fiscal policy, here too the general desirability of establishing an announced long-term goal and demonstrating a commitment to meet that goal should be made the principal focus.

Regulatory policy

The purpose of government regulation is to "correct" a perceived failure of the marketplace. The method of regulation is by legislative or bureaucratic edict instructing people and businesses on how they must behave under penalty of law. According to the theory of public choice, government regulation is often the product of populist political delusion. That is, the promotion of a regulation may be politically attractive when the costs of the regulation are widely dispersed among the unorganized many, while the benefits of the regulation are highly concentrated among a few well organized special interest groups.

Regulation has and will continue to serve a useful function. Our desire is that existing—as well as proposed—regulations be evaluated with respect to their consequences as well as their advertised intent. Most important, existing and proposed regulations must take into account the rapidly changing nature of global competition and the necessity of American businesses to be at the forefront of innovation and technological change.

International trade policy

In pursuit of improved living standards for their citizens, the nations of the world are growing increasingly interdependent through international trade, capital, and currency markets. The United States, by virtue of the economic growth stemming from its trade, fiscal, monetary and regulatory policies, has been the example and leader of this new tide of national economic interaction.

Open and fair international trade—in merchandise, services, and assets—will improve the efficiency in the use of global resources, expand output and benefit both buyers and sellers. But as with most of our dealings with foreign nations, it is always advisable to exercise caution, and "trust but verify."

FORECAST FOR 1989: THE EXPANSION CONTINUES

As in the previous two years, economic growth in 1989 will be driven by exports. Since 1986, U.S. exports of goods and services have climbed over $140 billion, resulting in 1988 net exports of −$93 billion (current dollars, NIPA). During the first four years of the current economic expansion, sluggish exports were a significant drag on GNP, and the trade deficit worsened. In 1986, the corner was turned and a declining trade deficit has had a positive effect on GNP growth.

Table I.1 summarizes the trends in GNP by major component. Noting that the economy is operating near its capacity and that our capacity is growing with investment, we expect further progress in 1989, with perhaps the inflation-adjusted merchandise exports figure improving to around $380 billion, from the $320 billion level registered in 1988. This development alone would account for a 0.7 percentage point increase in real GNP during 1989. If real increases in consumption, investment, and government purchases in 1989 were essentially the same as increases realized in 1988, and if import market share does not increase, year-over-year real GNP growth in 1989 would then register 3.7 percent. Presently, the Office of Management and Budget (OMB), the Congressional Budget Office (CBO), and "Blue Chip" forecasts for year-over-year real GNP growth for 1989 are 3.2 percent, 2.9 percent, and 2.7 percent respectively.

TABLE I.1.—REAL GNP AND ITS COMPONENTS, 1983–88

[In billions of constant (1982) dollars]

Activity	1988	1987	1986	1985	1984	1983
Consumption	2,592.1	2,521.0	2,455.2	2,354.8	2,249.3	2,146.0
Investment	721.3	674.8	643.5	637.0	658.4	504.0
Net exports	−99.7	−128.9	−137.5	−104.3	−84.0	−19.9
Government purchases	781.4	780.2	760.5	731.2	677.7	649.0
Total	3,995.1	3,847.0	3,721.7	3,618.7	3,501.4	3,279.1

CHANGES IN REAL GNP AND ITS COMPONENTS, 1983–88

[In billions of constant (1982) dollars]

Activity	1988	1987	1986	1985	1984	1983
Consumption	71.1	65.8	100.4	105.5	103.3	95.3
Investment	46.5	31.3	6.5	−21.4	154.4	56.7
Net exports	29.2	8.6	−33.2	−20.3	−64.1	−46.2
Government purchases	1.2	19.7	29.3	53.5	28.7	7.3
Total	148.0	125.4	103.0	117.3	222.3	113.1
Percent growth in real GNP	3.8	3.4	2.8	3.4	6.8	3.6

Source: Bureau of Economic Analysis.

However, the momentum of this economy—real year-over-year growth of 2.8 percent, 3.4 percent, and 3.8 percent since 1986—will not make the Federal Reserve's job an easy one. We suspect short-term interest rates during 1989 will go up while long-term rates, which are more reflective of expected changes in inflation, will remain quite stable this year. As a result, we only expect moderate declines in the real growth of consumption and investment. Continued adherence to Gramm-Rudman-Hollings would make the effect of government purchases neither a push nor a drag on GNP figures this year. Consequently, we believe the Administration's 3.2 percent real growth forecast for 1989 to be very achievable.

THE 1990S: CHALLENGES OF AN OPEN ECONOMY

The 1980s was a decade spent recovering from global inflation. The process is not complete, but it is far advanced. To build a strong foundation requires simple, conservative tools plus persistence. President Reagan succeeded in this. The challenge of the 1990s is not as clear cut. To do justice to the foundation we have in place will require creativity and insight. In particular, both the government and private sector will need to fight the complacency that has come with the successes of the 1980s.

We identify two challenges for public policy in the 1990s, beyond maintaining our solid foundation. First, we must move to a broader understanding of the consequences of our public policies. A number of issues relate to this "bigger picture" such as competitiveness. Federal tax, spending, and regulatory policies can and do impede industries' ability to compete abroad. Saving is another issue of great urgency, especially deficit reduction. Personal saving, too, must be encouraged, not only to enlarge our investment pool, but also to improve the financial wellbeing of individuals and families. Corporations, too, can benefit from taking a broader view. For example, planning and investing for maximum profitability involves a time horizon of many years, not just this year.

The second challenge involves centralization and decisionmaking. An inherent conflict pits our desire for an effective Federal Government against our knowledge that it is too removed from the people to make good decisions on all matters. The same is true for corporations: They want to grow profitably, but this can generate an inefficiently large span of control. An increasingly accepted management practice is to move decisionmaking authority downward in an organization, and to reward individual initiative. A crucial test in the 1990s will be applying this concept to our Federal Government. We note with interest an irony: While some U.S. policymakers clamor for a greater Federal role in the lives of individuals and greater intervention in the economy, other countries—Communist and democratic alike—are realizing immense benefits from their experiments of decentralization and market expansion.

These two challenges—understanding the full impact of public policy and taking a more modest view of the capabilities of the Federal Government and other large institutions—are examples of the issues we should pursue in the 1990s. Unlike the challenges of a decade ago, we don't face a crisis of national confidence. We face the complacency of a builder whose foundation is so strong that it invites more floors and thinner joists than necessary for comfortable living.

II. Economic Growth and the Rising Standard of Living

We continue to advocate noninflationary economic growth as the touchstone of economic policy. Economic growth is the key to job creation, higher family income, and a rising standard of living. The purpose of the Reagan-Bush economic program was to restore the basis for economic growth by reducing tax and regulatory barriers to the flow of factors used in production, thus increasing output. The program was implemented, and the longest peacetime expansion in U.S. history ensued. Though its opponents undoubtedly regard this as a coincidence, the Reagan-Bush Administration delivered on its promises, amid constant predictions of imminent failure. As a result, its tax cut program has been emulated around the world, most recently by the Social Democratic Party of Sweden.

Reagan-Bush policy focused on economic growth as a goal knowing that incomes at all levels would expand with the size of the economic pie. In the late 1970s, more attention was given to income distribution than economic growth, with the predictable result that all segments of the population realized a decline in real family income. The Reagan-Bush policy was to encourage economic growth, so that when successful, the level of income would rise for all groups. The data verify this assertion. The share of families earning less than $20,000 (1987 dollars) annually declined from 34.0 percent in 1982 to 30.3 percent in 1987.

THE RISE OF THE MIDDLE CLASS

The expansion also has led to unambiguous gains for the middle class. As middle income families became more affluent, a growing portion of families are moving into upper income levels. In the discussion that follows, families are classified by income as "lower" with incomes under $20,000, "middle" with incomes between $20,000 and $50,000, and "upper" with incomes above $50,000.

The share of low income families climbed from 30.4 percent in 1976, the last Ford year, to 31.9 percent in 1980. The share of high income families was unchanged at 17.5 percent in 1976 and 1980. Meanwhile, the proportion of middle income families declined from 52.0 percent to 50.7 percent, reflecting downward mobility into the lower income group. In other words, economic conditions for middle income families deteriorated, boosting the share falling into the lower income category. This deterioration was especially severe in 1980, when the low income share jumped 2.1 percent points in just one year.

Data from the next table show that the share of families classified as low income has diminished since 1980, while that classified as high income has increased sharply from 17.5 percent to 22.9 percent. The middle class share declined from 50.7 percent to 46.9 percent because more of them moved into the upper income group. Between 1980 and 1987 the share of high income families jumped 31 percent, virtually all the growth coming from the middle class.

TABLE II.1.—FAMILIES GROUPED BY INCOME

[Percent of total]

Year	Low income (under $20,000)	Middle income ($20,000-$50,000)	High income (over $50,000)
1973	28.4	52.3	19.3
1974	29.2	53.1	17.6
1975	31.2	52.3	16.4
1976	30.4	52.0	17.5
1977	30.1	51.3	18.6
1978	29.3	50.9	19.9
1979	29.8	50.8	19.4
1980	31.9	50.7	17.5
1981	33.7	49.4	16.9
1982	34.0	48.9	17.1
1983	33.6	48.4	17.9
1984	32.5	47.8	19.6
1985	32.0	47.4	20.6
1986	30.8	47.0	22.2
1987	30.3	46.9	22.9

Note.—Dollar values are derived in constant (1987) terms.

Source: Census Bureau.

As the table shows, the recent trend is favorable, with a smaller share of families since 1980 classified as lower income, and a greater share as upper income. This marks a reversal of the previous decade, when the combined share of middle and upper income families declined, while that of the lower income expanded.

The effect of economic growth on the middle class is also demonstrated by examining trends in median family income. As Table II.2 shows, middle American family income has risen 12 percent since 1982, even after adjustment for inflation. Real median family income, in fact, has grown in each of the last five years, from $27,591 in 1982 to $30,853 in 1987. A further substantial gain is expected for 1988 when figures become available.

GOOD JOBS AT GOOD WAGES

During the course of this expansion, 20 million new jobs have been created, according to the payroll survey. The civilian unemployment rate has declined to a level of 5.0 percent. Meanwhile, the civilian employment-population ratio—an important measure of the economy's ability to create enough new jobs, climbed to a level of 63.0 percent, a new record high. Given the objectives of the Employment Act of 1946, we are of the view that Reagan-Bush economic policies have proved highly successful.

TABLE II.2.—MEDIAN FAMILY INCOME TRENDS

[Constant (1987) dollars]

Year	Middie American family income	Change from previous year
1973	30,820	
1974	29,735	−1,085
1975	28,970	−765
1976	29,863	893
1977	30,025	162
1978	30,730	705
1979	30,669	−61
1980	28,996	−1,673
1981	27,977	−1,019
1982	27,591	−386
1983	28,147	556
1984	28,923	776
1985	29,302	379
1986	30,534	1,232
1987	30,853	319

Source: Census Bureau.

One of the most topical issues of labor economics is whether or not the United States has reached full employment, or the natural rate of unemployment. Though an interesting question in itself, it is even more significant that this debate is worth conducting at all. A new looming economic "threat" has even been identified: "overemployment," a buzzword referring to potential labor shortages. For those who like to focus on problems, this one certainly is preferable to slow growth, runaway inflation, and unemployment. Now is the first time in memory where "overemployment" has been identified as a problem.

It is clear that during this expansion the economy is creating many more jobs which require good education and skills. Current monthly employment data show that, for recent 12-month periods, the share of the net addition to employment accounted for by managerial and professional occupations ranges from 50 to 70 percent. The precision production, craft, and repair occupational group usually accounts for a goodly share of the remainder. Both of these occupational groups pay quite well relative to the average.

Thankfully, there has been relatively little mention in recent months about the supposed crisis of "bad jobs." As we have stated many times, the "bad jobs" fabrication was based on politics rather than economics from the start. This is demonstrated by the widespread recognition in Congress that the new jobs do require more education and training.

The next table displays employment and employment increases by occupation during this expansion. As can be seen, a disproportionate amount of the job growth is in the higher paid occupations.

TABLE II.3.—EMPLOYMENT BY OCCUPATIONAL CLASSIFICATION

[In millions]

Occupation	November 1982	November 1988	Change	Percent of net gains
Total, 16 and over	99.379	116.314	[1] 16.935	100
Managerial and professional	23.573	29.800	6.227	37
Technical, sales, and administrative support	31.017	35.863	4.846	29
Service	13.578	15.489	1.911	11
Precision production, craft, and repair	11.611	13.779	2.168	13
Operators, fabricators, and laborers	15.950	18.057	2.107	12
Farming and forestry	3.622	3.326	−.296	−2

[1] By another measure, the Establishment Survey, 19.3 million new jobs have been created between November 1982 and February 1989.

Source: Household Employment Survey, Bureau of Labor Statistics.

Most of the job gains occurred in occupations with above-average median earnings. Median 1988 weekly earnings for full-time managerial and professional occupations was $552; for technical, $448; sales, $385; administrative support, $318; precision production, craft and repair, $430; service, $245; operators and fabricators, $313; and farming and forestry, $229. The single largest contributor to net employment growth were the managerial and professional occupations, which posted a median equivalent annual income of $28,704. Altogether, a detailed breakdown of job growth by occupations shows that about three-quarters of the net gains were in occupations with median earnings of at least $20,000 annually. The point here is not that all of these new jobs paid fairly well, but that they were mostly in occupations that do pay fairly well.

In examining this issue, it is also useful to follow the 12-month pattern reported each month in the BLS monthly employment report. With managerial and professional occupations typically accounting for well over half of net employment gains, it is clear that employment growth has already shifted to occupations demanding higher skills, education, and expertise. According to BLS projections, this trend is expected to continue well into the future.

III. THE FEDERAL BUDGET

The recent fiscal history of the United States demonstrates that the Congress has had little success in, and perhaps little incentive to, restrain spending growth. By 1962, Federal spending had exceeded $100 billion for the first time since the formation of the Republic. By 1987, Federal spending reached the $1 trillion threshold. In real terms, Federal outlays in 1988 amounted to 258 percent of their 1960 level. By comparison, U.S. population stands at 136 percent of its 1960 level, and real defense spending is 132 percent of the 1960 figure. This extraordinary rise of Federal spending authorized by Congress is the source of our fiscal problems. Outlays have simply outpaced the strong revenue growth during this period.

Another way to examine components of the budget is by their relationship to GNP. Between 1960 and 1988, Federal outlays as a percentage of GNP jumped from 18.2 percent to 22.3 percent. Meanwhile, Federal revenues as a percentage of GNP climbed from 18.3 percent in 1960 to 19.0 percent in 1988. These trends converted a small surplus amounting to 0.1 percent of GNP in 1960 to large deficits by the mid-1980s. During the 1980s, the deficit share of GNP peaked at 6.3 percent in 1983 and had declined to 3.2 percent of GNP by 1988. Though too large, this is smaller than in 1975 and roughly the same as in 1980. As we pointed out in our report last year, the U.S. deficit share of GNP is comparable to that of most of our trading partners.

Table III.1 shows Federal spending, revenues, and deficits since 1960. These figures reflect an interesting contrast between trends in the GNP shares of revenues on the one hand, and outlays on the other. Over time, the revenue share of GNP has tended to fluctuate around its postwar average of 18.9 percent. However, between the early 1970s and the mid-1980s the Federal outlay share of GNP has trended upward. The beginning of this trend coincides with the adoption of the Congressional Budget and Impoundment Control Act of 1974, which limited the influence of the Executive Branch on the budget process.

TABLE III.1.—GROWTH OF FEDERAL SPENDING

[Selected fiscal years, 1960–89, dollars in billions]

Year	Outlays	Percent GNP	Revenue	Percent GNP	Deficit	Percent GNP
1960	$92.2	18.2	$92.5	18.3	0.3	0.1
1965	118.2	17.6	116.8	17.4	−1.4	.2
1970	195.6	19.8	192.8	19.5	−2.8	.3
1975	332.3	21.8	279.1	18.3	−53.2	3.5
1980	590.9	22.1	517.1	19.4	−73.8	2.8
1985	946.3	23.9	734.1	18.6	−212.3	5.4
1986	990.3	23.7	769.1	18.4	−221.2	5.3
1987	1,003.8	22.6	854.1	19.4	−149.7	3.4
1988	1,064.0	22.3	909.0	19.0	−155.1	3.2
1989	1,137.0	22.2	975.5	19.1	−161.5	3.2

Source: Office of Management and Budget.

The argument has been made that revenue growth during the 1980s has been unduly depressed by the 1981 tax cut. According to this argument, the current deficit problem results not from excessive congressional spending, but from slow revenue growth. This assertion does not stand up under examination. Federal revenues will have increased by $458 billion between 1980 and 1989, a rise of 89 percent. Even in real terms, this amounts to a gain of 27 percent.

In other words, this revenue increase was sufficient to finance $458 billion in additional Federal spending, without increasing the deficit. The core problem is that Federal spending will have climbed about $550 billion in the 1980s, an increase of over 90 percent. Congress has been unwilling to keep spending within the level of revenues, despite strong revenue growth. This points to an institutional problem within the Legislative Branch, which has regularly dominated the Executive Branch on spending levels.

The source of Federal revenues also changed in the 1980s. Previous Republican reports have made clear that the amount of taxes paid by the wealthy under the tax rate cuts of 1981 increased sharply through 1986. Moreover, the tax burden of middle income Americans was much lower than if the 1981 tax cuts had not been enacted. The policy of permitting inflation to push tax rates ever higher was stopped under the Economic Recovery Tax Act, which reduced personal income tax rates 23 percent across the board and indexed the tax brackets to prevent bracket creep. Independent calculations by both the CEA and Republican JEC staff have shown that 1986 Federal income tax payments by middle American families were about 27 percent lower than if pre-1981 tax law had remained in place. If the tax benefits provided under the 1981 legislation were reversed, it would result in an increase of income tax rates and payments of well over 30 percent.

BUDGET OUTLOOK

For several years now, the Republican Members of the JEC have pointed out that the key ingredient in deficit reduction is capping outlay growth. It is clear that the deficit can be reduced without new taxes, if Congress so desires. According to OMB, $82 billion in new revenue is projected in 1990. Over the next five complete fiscal years, CBO projects that $371 billion will be added to the annual revenue base under current law, which is already at record levels. It is our position that $371 billion in additional revenue is more than enough to deal with a $159 billion deficit.

The budget data demonstrate the validity of the flexibile freeze concept. If Congress caps the amount of total spending growth at about one half that of revenue growth, the deficit can be eliminated in five years (1989–93). The freeze is flexible because, within this constraint on spending increases, budget functions can be adjusted to reflect the priorities of policy. The baseline budget projections of OMB and CBO are displayed below. Under the budget law, the OMB forecast is used for the purposes of Gramm-Rudman deficit ceilings, while the CBO forecast is advisory. It is noteworthy that the CBO revenue forecast is somewhat more optimistic than that of OMB.

TABLE III.2.—OMB AND (CBO) BASELINE BUDGET PROJECTIONS

[In billions of dollars]

	1989	1990	1991	1992	1993	1994
Revenues	975.5	1,057.5	1,136.7	1,208.6	1,278.1	1,341.7
	(983)	(1,069)	(1,140)	(1,209)	(1,280)	(1,359)
Outlays	1,135.5	1,184.5	1,238.3	1,278.3	1,315.0	1,350.4
	(1,142)	(1,215)	(1,287)	(1,348)	(1,416)	(1,489)
Deficit	−160.0	−126.9	−101.6	−69.7	−36.9	−8.7
	(−159)	(−146)	(−146)	(−140)	(−135)	(−130)
Deficit target	−136	−100	−64	−28	0	

Source: Office of Management and Budget and Congressional Budget Office

We support President Bush's approach to the flexible freeze budget for FY 1990. In addition, we are supportive of the overall policy view proposed in the President's budget.

It is particularly important that we leave the current services baseline behind us, as the President proposes. The current services concept locks an upward bias into Federal spending, creating a system of perpetual growth. By mechanically using up a substantial portion of the new revenues coming to the government, it allows Congress to avoid decisions at the expense of immortalizing low priority programs. Instead of the current services baseline, the common sense and real world notion of actual spending levels from the previous fiscal year should be used as a baseline for budget policy.

If Congress is unwilling to take the necessary steps to trim 1990 spending growth by the $16 billion required by law (assuming the $10 billion cushion), sequestration will be invoked to bring the deficit down to the $100 billion ceiling under Gramm-Rudman. The composition of spending reductions under a Gramm-Rudman sequestration is not desirable. Thus, it is critical that Congress attain fiscal restraint before the sequester mechanism is invoked. Moreover, a reduction in 1990 budget authority sufficient to reduce outlays by the required amount in 1990 may well reduce outyear outlay growth by an even larger amount than that in 1990, as the cut in budget authority is "paid out" over several years.

We concur with the majority of the National Economic Commission that tax increases are not the way to address the budget situation. First, a tax increase could undermine economic growth, thereby raising the deficit. Moreover, as a number of studies have pointed out, a tax increase likely will be used by Congress to increase its spending. A tax increase is inappropriate also because it diverts attention from the real issue—authentic and lasting deficit reduction cannot be achieved without slowing the growth of Federal spending.

By law, any Social Security surplus must be invested entirely in special U.S. Treasury securities. We insist that the Social Security trust funds be protected from any diversion. The integrity of these trust funds must be inviolable, and none should be used for any purpose other than that of providing retirement security. We reject any attempt to use Social Security funds for any other purposes or expenditures at the Federal, state, or local levels.

We are impatient with the growing fascination of the on-budget and off-budget treatment for various spending programs. Two years ago, assets sales were excluded from the Gramm-Rudman deficit calculation, largely to encourage the government to hold on to assets that could be better managed by the private sector. Last year, there were proposals to change yet again the budget treatment of the Social Security programs by excluding them from Gramm-Rudman calculations. This year, much attention has been given to including past and future losses stemming from the savings and loan crisis, in an effort to force tax increases.

In place of these esoteric exercises, we propose instead a simple observation: By whatever measure, the deficit is too big, both now and in the foreseeable future, and there is an urgency to restraining the growth of spending. The sincerity of Congress in dealing with our fiscal problems can be gauged by the number and cost of new spending approved in the current session.

THE RISE OF FACTION AND EROSION OF DEMOCRATIC INSTITUTIONS

As we have pointed out in previous reports, the economic argument that it was sometimes appropriate for government to create deficits had an unintended but negative effect on policymaking. Through most of American history, the balanced budget rule was powerful enough to be considered part of the unwritten constitution. According to Nobel Laureate James Buchanan, once the "taboo" against deficit spending was broken in the early 1960s, an important constraint on government spending was removed. The result was that Federal spending then expanded both in absolute amount and as a percentage of the economy.

Institutional reforms to improve congressional decisionmaking are essential, and we reiterate our support of a balanced budget/tax limitation constitutional amendment; a judicial test of innate executive power to exercise a line-item veto, or, if unsuccessful, adoption of a line-item veto by Congress; disuse in the budget process of the current services baseline budget (which assumes spending growth as given), with the substitution of prior-year budget levels as the baseline for budget policy; and a biennial budget process.

We advocate these institutional reforms as a way to improve consideration of the costs and benefits of Federal spending, which we believe would slow budget growth. The resources directly and indirectly diverted from the private sector as a result of excessive congressional spending undermines the ability of the private economy to expand. While the economic consequences of this trend are serious, the negative effects on democratic institutions also merit consideration.

As the Framers and The Federalist made clear, the Constitution set forth the organs, rules, and procedures of the U.S. Government so as to limit arbitrary exercise of government power in order to protect individual rights, provide for the common defense, and for other purposes. The central government was divided against itself by the checks and balances of its three branches, and the state governments from the central government, in order to diffuse government power within the Federal system. Though there were differences of opinion among the Framers as to which branches, departments, and levels of government posed the gravest potential danger to liberty, there was broad agreement that government power should be limited and that unbridled government was dangerous.

This conclusion was based on political history from ancient Greece and Rome to George III. The Framers went about their work without utopian delusions about changing human nature, but with the practical objective of designing a system that did not completely depend upon the virtue of politicians and office holders. As Madison pointed out in The Federalist No. 51, "If men were angels, no government would be necessary. If angels were to govern men, neither external nor internal controls on government would be necessary."

This view of politics also leads to the conclusion that temporary coalitions of special interests must be controlled to protect the general welfare. In The Federalist No. 10, James Madison offered the following observation:

> Among the numerous advantages promised by a well constructed Union, none deserves to be more accurately developed than its tendency to break and control the violence of faction. * * * By a faction, I understand a number of citizens, whether amounting to a majority or minority of the whole, who are united and actuated by some common impulse of passion, or of interest, adverse to the rights of other citizens, or to the permanent and aggregate interests of the community. * * * To secure the public good and private rights against the danger of such a faction, and at the same time to preserve the spirit and the form of popular government, is then the great object to which our inquiries are directed.

Control of faction, or special interest, is clearly seen by Madison as a primary purpose of the Constitution. Often described as the father of the Constitution, Madison envisioned a republican form of representation designed to check and control the power of faction. Rules and procedures established under the Constitution function to protect individual rights and limit the power of special interests to dictate public policy. This suggests that removal or erosion of rules governing congressional decisionmaking will affect the substance of policy.

One key aspect of our fiscal problem is that the benefits of each congressional spending measure are concentrated, while the costs are diffused over all taxpayers. Therefore, each item of spending enjoys intense support among interested and usually well-organized groups, while the costs to each taxpayer are not felt as intensely or considered as carefully. Moreover, coalitions of special interest groups can form to push jointly many otherwise separate spending measures, and logrolling in the legislative process can facilitate the adoption of the coalition program. This situation suggests the need for rules to prevent such an outcome.

As discussed earlier, the expansion of government over the last three decades reflects the relaxation of the deficit rule. This, in turn, has set in motion forces which undermine other weaker institutional constraints, such as the requirement for votes on increasing the debt limit, timely consideration of the budget, and effectiveness of the veto. As institutional constraints on congressional spending have become less important, the scope and size of government have grown The growth of government has qualitatively altered our system of government and undermined the rule of law and congressional consideration of fiscal matters.

The moral and political results of this tendency have been described by Nobel Laureate F.A. Hayek. Increasingly, the character of lawmaking has shifted from the universal application of fundamental principles to the provision of specific benefits to special interest groups in response to political pressure. According to Hayek, in Law, Legislation and Liberty:

> An assembly with power to vote on benefits to particular groups must become one in which bargains or deals among the majority rather than substantive agreement on the merits of the different claims will decide. The fictitious "will of the majority" emerging from this bargaining process is no more than an agreement to assist its supporters at the expense of the rest. It is to the awareness of this fact that policy is largely determined by a series of deals with special interests that "politics" owes its bad reputation among ordinary men. * * * Only limited government can be decent government, because there does not exist (and cannot exist) general moral rules for the assignments of particular benefits (as Kant put it, because "welfare has no principle but depends on the material content of the will and therefore is incapable of a general principle"). It is not democracy or representative government as such, but the particular institution, chosen by us, of a single omnipotent "legislature" that make it necessarily corrupt.
>
> Corrupt at the same time weak: unable to resist pressure from the component groups the governing majority must do what it can do to gratify the wishes of the groups from which it needs support, however, harmful to the rest such measures may be—at least so long as this is not too easily seen or the groups who have to suffer are not too popular. While immensely and oppressively powerful and able to overwhelm all resistance from a minority, it is wholly incapable of pursuing a consistent course of action, lurching like a steam roller driven by one who is drunk. If no superior judiciary authority can prevent the legislature from granting privileges to particular groups there is no limit to the backmail to which government will be subject.

Fortunately, the U.S. Government has not yet reached this state. However, the expanding ability and willingness of Congress to purchase political support at public expense corrodes the integrity of the Congress and undermines public respect for our institutions.

The moral dangers of excessive Federal spending put the institutions of our government at risk. In addition to the economic costs imposed, the costs incurred by questions about the integrity of government are also gravely serious. Thus, fiscal profligacy is hazardous to both our economic and political well-being.

IV. International Trade: Review and Prospects

While the nations of the world retain their political and cultural identities, the rapid growth in the international exchange of goods and services has drawn them closer together. During the period 1950 to 1986, world trade, in real terms, grew more than 800 percent. The Reagan Administration vigorously promoted this growth in economic interdependence through its policies of anti-protectionism at home and forceful market-opening efforts abroad. The continued pursuit of a truly open-world trading system and the improvement in global standards of living go hand in hand.

THE DYNAMICS OF AN OPEN SYSTEM

Adam Smith, with the publication of The Wealth of Nations in 1776, is generally credited with founding the modern science of economics. Other work preceded Smith's, but his was the first general exposition of economics to have a profound impact on public affairs, and the way men have come to see the world and its economic potential.

What made Smith's arguments so influential was his demonstration of the dynamics of an open system—the direct and indirect consequences of policies and the regular behavior of open markets. Adam Smith used no statistical tools, nor was he concerned with a short-run macroeconomic phenomena. What may be good for society in the long run may be just as bad for identifiable groups within society, even whole nations, in both the short and long run. The task of modern economists increasingly has become to find strategies consistent with the long-run success of everyone, but which discomfort the fewest people in the short run.

The economics of enlarged markets

Adam Smith wrote of the benefits of specialization—the division of labor, as workers in a cooperative effort focus on learning how to perfect the smallest function in a larger project. Specialization is the foundation of a capitalistic competitive economy, and no one—particulary an American—questions this insight in his own life. Any time one's car needs servicing, the home needs repair, or some new delicacy graces the dinner table, we appreciate the benefits of somebody else's special talents.

How far can or should this specialization process go, whether in the U.S. or global context? The continual movement of the production process into ever new combinations of ideas and techniques to solve old problems is the primary source of discomfort and economic dislocation or large numbers of our fellows. It is competition from newcomers, domestic or foreign, offering lower prices or higher quality that breaks down old customers' loyalty and jeopardizes the economic status of market leaders and the jobs of their employees.

To pose the problems of economic change in these terms is to make the very case for it. Adam Smith observed that production requires labor, capital, and land or raw materials, and that there exists an optimal mixture of these components to produce the most output of every single product or service with the least input. The task of an entrepreneur is to find that optimum—and to find it again when it changes, because it changes whenever someone else has a better idea.

The larger the extent of the competitive market, the more entrepreneurs are born. The more efficient the use of available resources, the greater the variety and quality of goods and services. The larger the competitive market, the greater the breadth of economic progress and the well-being of society.

The politics of enlarged markets

Competition, as described above, is at once a threat and a benefit. In the short run, one person's choosing a new supplier can cause distress to the old one, even if the new supplier has something cheaper, more efficient, and better for society. Hence, the politics of enlarged markets enters the picture. To protect workers, businesses, products, or even entire industries from the threat of heightened competition, artificial, arbitrary trade barriers are erected. Just as the OPEC cartel found enormous profits in making petroleum relatively scarce in the 1970s, advocates of trade protectionism around the world try—and often succeed—in closing markets against their competitors, in order to make their goods and services artifically scarcer in a local market.

To open world markets for American producers, our trade negotiators need to use forceful tactics. The most powerful tactic, however, will not be the threat of retaliation, but an awareness that a country's protectionism hurts its own people more than any others. If this knowledge can be used aggressively, foreign negotiators will find that their own internal politics forces them toward more open markets.

The habitual use of emotional "us against them" appeals can degenerate into excuses for closing America's markets slowly but steadily with trade retaliations. U.S. Trade Representative Carla A. Hills has indicated an awareness of this problem. She told the Senate Finance Committee at her confirmation hearings, "We do not regard our unilateral tools as the ultimate purpose of our trade policy, by no means. We are not a retaliatory nation by choice." Indeed, the 30-year history of U.S. trade retaliation has shown few examples of success in forcing open a foreign market in Europe, Latin America, Africa, or Asia.

U.S. AND GLOBAL TRADE DEVELOPMENTS

It was a popular perception only a few years ago that the United States was doomed to follow in the steps of such once-great and powerful nations as the Roman, Ottoman, and British empires: The United States had become a debtor nation, was racking up catastrophic deficits, and had lost its competitive edge. Its international leadership role was rapidly deteriorating. While the challenge has never been greater, the news of America's demise was greatly exaggerated.

As JEC Republicans anticipated last year, the United States experienced a highly positive shift in export/import flows in 1988—and there is reason to believe that similar good fortune awaits us in 1989, and beyond. This shift is reflected in a 1987–88, year-over-year, $63 billion increase in U.S. merchandise exports, moving from $254 billion to an estimated $317 billion. Although still large, America's external imbalance is significantly declining. Recent Organization for Economic Cooperation and Development (OECD) projections indicate a parallel reduction in the size of the current account deficit as a percentage of U.S. gross national product, moving from 3.3 percent in 1986 to an estimated 1.9 percent by 1990.

International trade is an engine of world economic growth, which benefits all trading nations. According to the International Monetary Fund (IMF), close to one-third of the overall growth in world trade last year was derived from American imports and exports. The IMF further points out that in contrast with the past, when expanded global trade volumes were largely a result of surging U.S. imports, the new trend is moving in the other direction: By 1989, reports the IMF in its most recent World Economic Outlook, "U.S. exporters are expected to have regained most of the losses of market shares experienced between 1981 and 1985."

This good news has not been a flash in the pan. Improvements in the U.S. trade account have been evident since early 1986. Between then and the end of 1987, America's export volume jumped by 18.6 percent, while import volume rose by 11.5 percent. If anything, the new figures indicate that we have underestimated America's long-term competitive strength. Last year's export boom, then, should provide us with a strong incentive to stay on current course.

Three key reasons justify confidence in America's ability to compete abroad: First, the positive effects of a cheaper dollar, which reduces the foreign price of most American exports while making imports more expensive, have taken longer than expected to adjust trade flows. Second, the export offensive is powered by a broad-based product and geographic base—from high-technology to agriculture to services. Finally, positive macroeconomic shifts in Western countries have enabled the United States to sell larger volumes of goods there. With no world recession in sight, U.S. exports likely will continue to grow, even if a slight slowdown in foreign domestic demand occurs.

The good news extends beyond the OECD area, too. Changes in a number of advanced developing countries also helped the United States. Korea's program to spur domestic growth and consumption deserves special attention. Over the long term, such an emphasis will allow it to reduce dependence on exports as an engine of growth, while lifting the standard of living. There are encouraging portents. Fully one-half of Korea's gross national product growth in 1987 came from domestically generated demand. With salaries on the rise, personal consumption continues to increase. Of course, Korea has a way to go. Last November, a Korean presidential commission on economic restructuring issued a final report supporting accelerated efforts to stimulate domestic growth. When it was at a comparable level of economic development, Japan was not even contemplating such a shift.

U.S. imbalances with its various partners will not, and need not, disappear overnight. Indeed, an effort to bring about such a result through a full-fledged, demand-throttling recession, for example, would do inestimable harm to the increasingly internationalized American economy, and generate turmoil in the global trade and financial markets. Rather than engage in a crash program to reduce the trade deficit through import restraint, the United States would be better advised to direct its energies toward achieving consistent, year-over-year, improvements in U.S. export performance—within the context of an open, international economy.

THE AMERICAN CHALLENGE AHEAD

The United States has ample reason to be proud of its recent trade performance. Clearly, this is the message behind last year's dramatic increase in U.S. exports. But the future will require, if anything, greater American efforts to improve our competitive position.

Despite a chorus of anxious voices calling on the United States to embrace more isolationist foreign economic policies, the general direction of U.S. trade policy has proven itself to be correct. The United States would be better advised to continue the promotion of expanded U.S. exports, greater overseas growth, and market liberalization, plus enhanced U.S. efforts to further improve the existing bilateral and multilateral trade liberalization mechanisms.

The long awaited decline in the trade deficit this year has raised as many questions as it has answered. Many economists expected the 32 percent fall in the value of the dollar since 1985 to have caused the deficit to drop far sooner than it did. The fact that this did not happen suggests that other widely held beliefs may also be wrong.

One common perception is that the improvement in the trade balance is almost complete. Many econometric models predict that most of the improvement in the trade balance has already occurred, and, therefore, expect a widening of the gap in another year or so, if there is no further decline in the dollar.

Others, however, believe that the adjustment is not yet complete and that there is room for considerable improvement in the deficit over the next few years at current dollar levels. These views are based in part on the strength of export orders and long-term gains in U.S. overseas competitiveness stemming in part from the dollar depreciation.

The purpose of this section of Chapter IV is to examine trade implications more closely. The first part will set the stage by analyzing the crucial relationship between the trade deficit and the economic successes of recent years. The second will describe the mechanics of and outlook for the adjustment currently underway.

The trade deficit and the U.S. economy

On the whole, running a trade deficit can be beneficial to an economy, but only as long as the investment surplus associated with it is invested well. The reasons are simple. A trade deficit allows a country to consume more than it produces and invest more than it saves. With strong domestic demand, trade deficits thus permit a country to maintain a higher investment level and standard of living than would be possible if forced to balance its trade.

The U.S. experience during the 1980s is an illustration of this point. Between 1978 and 1986, GNP per worker only rose 4.5 percent. However, personal consumption and government spending per worker jumped 9.8 percent and 12 percent, respectively. Without a trade deficit, the only way this could have happened is if investment were cut drastically. However, investment per worker only dropped slightly. The strong domestic demand was made possible by shifting employment and resources away from exports and toward domestic consumption and imports. In other words, the economy ran a trade deficit.

Another way of looking at the same issue is to focus on financing U.S. investment. The current account deficit (the goods and services trade deficit plus net earnings on overseas investment) is not only the excess of what we buy over what we produce, it is also equal to the excess of what we invest over what we save. The reason is straightforward. If, because of favorable economic conditions, foreigners want to invest in our country more than they want to buy our goods, bhey must run a current account surplus with us. This surplus takes the form of capital inflows to this country that add to the savings pool available for investment. Because of this process, total investment in the United States is currently higher than domestic savings.

Foreign investment in the United States recently has become elevated as a policy issue in the political arena. Among the concerns are potential impacts on national security, sovereignty, and technology transfer. While these concerns are understandable, no serious threat has emerged. Foreign investment has been and continues to be a boon to the economy. Without the inflow of capital from abroad, government borrowing to finance the Federal budget deficit could have led to the "crowding out" of private investment. The Institute for International Economics estimates that interest rates would be 3 to 5 percentage points higher in the absence of foreign investment. Instead, we have been the beneficiaries of $983 billion in foreign money since 1981. This capital has provided productive investment in plant and equipment, the stock and bond markets, and the banking sector.

Some are concerned that these capital flows are adding to our stock of foreign debt and have made us the world's largest debtor country. We certainly cannot ignore this trend. But first we must note much of this "debt" is actually equity. Second, there is substantial evidence that the value of U.S. assets abroad is much greater (by hundreds of billions of dollars) than is reflected in the statistics. Also, the level of our indebtedness is denominated in our own currency, and is small in relation to the size of the economy—less than 10 percent of GNP, compared with 70 percent for Mexico, for example.

The adjustment process

The adjustment process is well under way. The balance has been narrowing since late 1987. The merchandise trade deficit fell from $160 billion in 1987 to $127 billion in 1988. Exports, as shown in Table IV.1, have expanded to virtually all U.S. trading partners, including the Asian newly industrialized countries (NICs) whose markets had formerly proven difficult to penetrate. In addition, U.S. consumers and businesses have finally shifted away from imported goods. Import volumes have declined in most categories. The exception, the booming capital goods sector, is a positive sign that our productive capacity is growing.

TABLE IV.1.—U.S. EXPORTS BY TRADE PARTNER

[Annual percent change from previous year, measured in dollars]

Trading partner	Average 1983–86	1987	1988
Total	3.3	11.9	26.8
Canada	8.6	7.8	18.5
European Community	3.1	14.0	25.2

TABLE IV.1.—U.S. EXPORTS BY TRADE PARTNER—Continued

[Annual percent change from previous year, measured in dollars]

Trading partner	Average 1983–86	1987	1988
Japan	7.1	5.1	33.6
4 Asian NIC's [1]	2.6	28.7	[2] 48.5
Other	–.9	10.5	25.3

[1] Hong Kong, Korea, Singapore, and Taiwan.
[2] Inflated by nonrecurring gold shipments.

Source: Commerce Department.

To argue that the trade balance will continue to improve, we must first reconcile two opposing theories of exchange rate movements. The traditional school claims that the dollar will move in whatever direction necessary to balance the current account (holding financial market expectations constant). The purchasing power parity (PPP) theory, on the other hand, is based on the "law of one price," which says that goods and services should cost the same in all countries when measured in a common currency. The implication of the PPP school is that movements in the nominal value of a currency alone can have no lasting effect on competitiveness. Consequently, changes in the currency's nominal value cannot be used to eliminate the current account deficit.

In response, the traditional school would claim that movement toward PPP can be impeded by consumer preferences and trade barries, so that the equilibrium exchange rate may differ from PPP. Most estimates for the dollar PPP are around 200 yen and 2.20 Deutsche marks (West Germany). With the dollar currently trading at around ¥126 and DM1.82, it is safe to say that, according to PPP theory, the dollar is substantially undervalued at this point. Many economists believe, however, that if the dollar were at its PPP, America's current account deficit would continue to grow and its resultant foreign debt would rise indefinitely.

Reconciling these two schools of thought is not as difficult as it appears, if the problem is considered in terms of a time-scale. The PPP is in equilibrium only in the long term because it takes time for price equalization to work through the system. In the short term, exchange rates may need to differ from PPP to help trade flows adjust. It can be argued that the narrowing of the U.S. trade deficit so far has only been due to short-term considerations, and that the enhanced competitiveness implicit in a long-run PPP theory has yet to be fully felt.

Research by Peter Hooper for the Brookings Institution offers evidence strongly showing that U.S. competitiveness has indeed improved since the beginning of the dollar depreciation in 1985. Table IV.2 presents some estimates of the levels of labor costs in total manufacturing in the United States and a group of eight other industrialized countries. The table shows that U.S. relative labor costs and productivity are now far more competitive than they were a few years ago. U.S. compensation per hour is nearly on par with that of other industrialized countries, while productivity measured by output per hour is outstripping that of other industrialized countries. As a result, the U.S. competitive position in the production of goods and services has vastly improved.

TABLE IV.2.—COMPARATIVE LABOR COSTS AND PRODUCTIVITY IN THE UNITED STATES AND OTHER INDUSTRIAL COUNTRIES

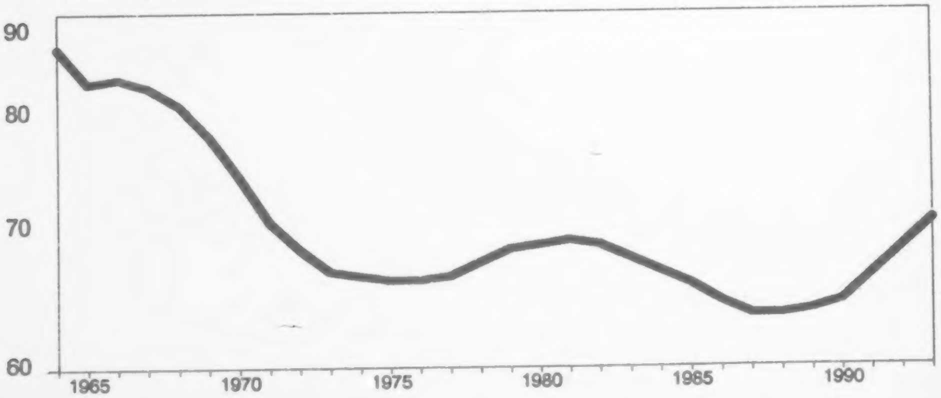
	1980	1985	1988
Compensation per hour (current dollars):			
United States	9.8	13.0	14.2
Foreign [1]	8.4	7.7	13.3
Productivity—output/hour (1980 dollars):			
United States	15.5	18.4	20.3
Foreign [1]	11.0	13.9	16.1
Unit labor costs (ratio of compensation per hour to output per hour):			
United States	66	71	70
Foreign [1]	76	55	88

[1] Canada, Japan, Germany, France, the United Kingdom, Italy, Belgium, the Netherlands, Denmark, and Norway.

Source: "Exchange Rates and U.S. External Adjustment in the Short Run and the Long Run," by Peter Hooper; Brookings Discussion Papers, No. 65, October 1988.

Labor cost and productivity advantages should induce capital formation. Firms can be expected to expand plant capacity in the United States because of these cost benefits. Chart IV.1 shows estimates of the relative capital stocks of the United States and foreign industrialized countries. Capital stocks are a crude way of measuring an economy's output capacity. The forecasts predict U.S. capital stock to rise in comparison to those in foreign industrialized countries over the next several years. This capital formation is particularly important in light of the expected slowdown in labor force growth in the 1990s.

Chart IV.1
RELATIVE CAPITAL STOCKS, U.S./FOREIGN[1]
In Percent, Ratio Scale



[1] Foreign includes average of Japan, West Germany, France, Canada, and the United Kingdom, in dollars, weighted by manufacturing output.

NOTE: Calculated from OECD estimates of U.S. and foreign real capital stocks in manufacturing, measured in 1980 dollars. Years beyond 1986 are estimates.

SOURCE: See Table IV.2.

Increased output capacity will be welcome for other reasons as well. Anecdotal evidence suggests that U.S. exports have been increasingly limited by capacity constraints, and that companies have been importing capital goods to expand output capacity. According to Chairman Greenspan, internal Federal Reserve statistics show that orders for exports are currently surpassing present export figures. In addition, foreign direct investment in the United States could add substantial capacity in import-competing and some export industries. Once that capacity comes on stream, the trade deficit could show considerable improvement—without a further dollar depreciation.

It is not surprising that most models of the economy are not predicting much further improvement in the trade deficit. The models are generally demand-oriented and, therefore, are not successful at reflecting impacts occurring in the production side of the economy—the supply side. The initial J-Curve effects of the dollar depreciation are predicted, but the longer run impacts are not captured very well. Unfortunately, attempts to incorporate supply-side effects into existing models have yielded inconclusive results. The long-run impacts are exceedingly difficult to model and, therefore, have left some ambiguity around this line of thought.

In addition, there are developments that could thwart the trade balance improvement. A recession abroad could leave U.S. producers with a lot of unused capacity. The OECD does not predict a recession for its member nations, but it does anticipate a slowing of domestic demand growth from 4 percent in 1988 to 3.25 percent in 1989 and 2.75 percent in 1990.

Also, because the United States is becoming such a desirable place to locate production, foreign demand for dollars could accelerate its rise again if a substantial amount of foreign production shifts here. This demand could cause an appreciation of the dollar, which could lead to a widening rather than a decline in the trade deficit.

Nevertheless, a further narrowing of the trade deficit at current exchange rates is possible. In fact, substantial improvement in trade in combination with strong domestic demand could lead to inflationary pressures, if monetary policy were to relax. Booming exports along with strong domestic investment and consumption would result in GNP growth for 1989 substantially higher than anyone currently anticipates. To avoid a dangerously overheating economy, the anticipated growth in U.S. exports should be accommodated by cutting the budget deficit by reducing growth of government purchases, as President Bush has proposed.

THE INHERENT STRENGTH OF AN OPENNESS STRATEGY

American international economic policy is at a crossroads. Almost a half century ago, America led an alliance that conquered the world militarily and this Nation towered over our nearest rival, the broken British empire. Not only have we come to realize that the United States no longer dominates the world—because others have learned from our universities and imitated our industrial system—but also because the United States is in the truest sense an embodiment of the crossroads of the world. President

Reagan spoke at Moscow University last year with the metaphor that anyone can become an American. Walt Whitman wrote over a century ago, "America is the race of races," in describing the ethnic and cultural diversity of the new land.

Throughout the 19th century, this country ran a perpetual trade deficit, as we imported capital and labor from every other corner of the world. There was no other land mass so underpopulated and at the same time so completely free of government regulation and taxation, free of local monopolies, and free of traditional social roles to bind and crush the spirit of entrepreneurship.

In the 1980s, much concern has been voiced about America's relative decline, when in fact we have advanced rapidly. Just as Adam Smith would point out, the equalization of returns to everyone's marginal labor, land, and capital, which a free, international market will everywhere tend to produce, must eventually bring the rest of the world up to America's level. Many countries are following the U.S. model and have adopted policies of widespread deregulation and rapid economic growth. Advances in telecommunications and transportation, uniting the business centers of every country as never before, have produced a worldwide connectivity that was only seen previously in the continental United States.

The leadership of the United States in world economic progress and innovation, however, is essentially unchallenged. One paramount fact proves it: Since the 1970s, the United States has accepted more legal immigrants than the rest of the world combined. America by the 1990s will have a younger population than any of our rivals. In Europe there is a phobia of immigration and an absolute decline in the population levels. Germany's population is expected to decline nearly 50 percent by the mid-21st century. In Japan, by the end of the century the percentage of retirees drawing consumption from the gross national product, but producing nothing, will be nearly twice ours.

Joel Kotkin, author of The Third Century: America's Resurgence in the Asian Era, has noted that we have gained far more than just an augmentation to the labor force:

> Hispanic influence has transformed Miami into the banking capital of Latin America, while on a smaller scale boosting San Antonio and San Diego into business centers for rapidly industrializing northern Mexico. Asian immigrants have turned Los Angeles and San Francisco into dynamic centers or Oriental capitalism.

The economic contributions by our immigrants reflects a greater source of American strength—the openness of our economic system. This flexibility, allowing for the birth and death of companies on a massive scale, has produced in the past decade a resurgence of entrepreneurial enterprise admired around the world. As Peter Drucker has noted, "America shares equally in the crisis that afflicts all developed countries. But in entrepreneurship—in creating the different and the new—the United States is way out in front."

His book is replete with example after example of new businesses successfully growing with immigrant labor and entrepreneurship. Kotkin is the West Coast editor of Inc. magazine, which has chronicled this trend in the past decade. He cites some interesting statistics:

> While large firms shed nearly 1.4 million factory jobs between 1974 and 1984, nearly 41,000 new industrial companies have offset almost all this loss. As a result, companies employing fewer than 250 employees have increased their share of American manufacturing employment to 46 percent, up from 42 percent a decade ago. If this trend continues, small firms could employ 50 percent of our industrial work force by the 1990s.

In addition to the trend toward smaller and more innovative companies, Kotkin notes "a new breed of American industrialists," which he identifies with the post-Vietnam generation. He says, "Unlike the prototypical managers of the 1960s and 1970s, they have gained the wisdom not to assume American supremacy. At the same time, these executives—many only in their 20s and 30s—have no desire to hand the keys of the future to Asian competitors."

But holding center stage as the world's cultural and economic crossroads has always required us to adapt to whatever new forces swept our shores. In the 19th century, government did not attempt to limit immigration or regulate foreign investment, but such laissez faire philosophy is rare today. With the renewal of faith in capitalism worldwide, the highly developed markets in the United States have served increasingly as the cybernetic center of the world economy.

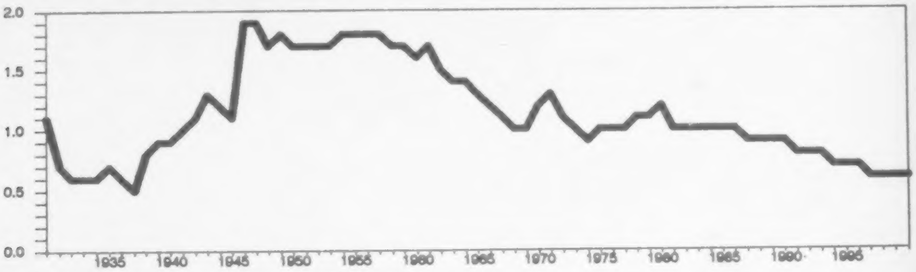
The growing foreign involvement in American financial markets has raised questions about some need for government regulation. This emerging debate itself represents a policy crossroads that may significantly affect America's future. The United States has been in the past a leader in advocating open capital markets and non-discrimination against investment—an easy enough position to take when we were temporarily a capital exporting nation. But now that investment is surging into this country again, a growing anxiety in Congress has appeared. As this new policy debate is joined, the inherent strength of an openness strategy should ultimately prevail.

V. Demographic Change and Its Economic Implications

A demographic wave is surging through U.S. society, and its wake will have a profound effect on our economy. The significance of this transformation is punctuated by a parallel trend at work: the U.S. workplace is undergoing a technological revolution—a job wave. Acting in tandem, these waves portend major changes in America's not-so-distant future.

The baby boom generation, now entering a middle age, is the crest of the demographic wave. Flanking it are troughs of birth dearth—periods where birth rates and population growth slowed. Preceding the baby boom (those born between 1946 and 1964), two dramatic events slowed population growth, the Great Depression and World War II. The years following the boom were marked with a natural slowdown, while the baby boomers grew up. Presently, due to many social changes, the growth rate associated with baby boomers will not be as high as it was for the previous generation. The wave is illustrated by Chart V.1, which tracks population growth trends and projections from 1930 to 2000.

Chart V.1
THE POPULATION WAVE
Annual Percent Change in the U.S.Population, 1930-2000



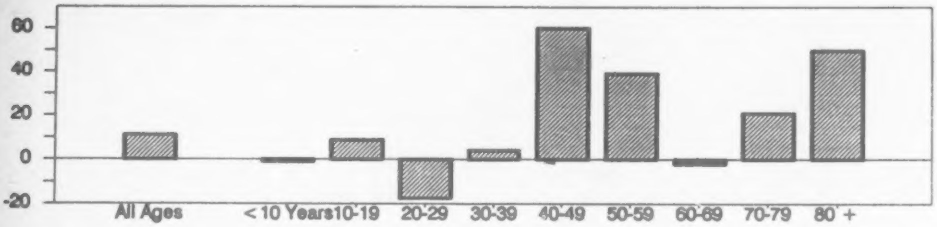
SOURCE: Census Bureau, various publications.

The waves are not just population and job numbers—their characteristics are equally important. Among the population traits are changes in age, race and ethnic background, education, skills, locality, dispersion, family size, household makeup, labor force composition, etc. On the job side, the full impact of the high-tech, service-intensive, information age emerges. Machines, whether robots on the assembly line or personal computers in the secretarial suite, are being utilized, making human operators more productive and proficient. Consequently, the demand for certain kinds of worker skills is changing radically. Of crucial importance to the workplace of the future is the training, adaptability, and resourcefulness of workers.

A DEMOGRAPHIC PROFILE OF THE UNITED STATES

Even if population growth rates have receded in recent years, total population is expected to increase by 11 percent, or almost 27 million people between 1986 and 2000. With the aging of the baby boom, median age will increase from 31.7 years to 36.5. In those 14 years, the number of persons in their 40s will have grown by 60 percent. Two other age cohorts show dramatic increases—the number of persons over 80 will increase 50 percent and those in their 50s will grow slightly under 40 percent. One age group—the 20s—will find their numbers decline significantly, by an estimated 17 percent. Chart V.2 illustrates these age shifts.

Chart V.2
PERCENTAGE CHANGE IN U.S. POPULATION, 1986-2000
By Age Cohort



SOURCE: Census Bureau.

Variations by sex show only slight change. The growth rate for men is expected to be slightly higher than women, but the number of women will still exceed men by about 6 million, about the same as in 1986. While women's share of total population will remain stable, a much larger shift will occur by race and ethnic origin. Black, Hispanic, and Asian populations will grow much faster than the traditional white population. Minorities thus will claim a larger share of the U.S. population. In rough estimates, that share will increase from about 23 percent presently to 26 percent in the year 2000. Table V.1 lists the anticipated changes in U.S. population by sex and race/origin.

TABLE V.1.—U.S. POPULATION, 1986 AND 2000

[In millions]

Group	Population 1986	Population 2000	Change 1986-2000	Percent change 1986-2000
U.S. total	241.1	267.7	26.6	11.1
Male	117.4	130.7	13.3	11.3
Female	123.7	137.0	13.4	10.8
Black	29.3	35.0	5.7	19.5
Hispanic [1]	18.1	25.2	7.1	39.2
Asian [2]	5.0	9.9	4.9	98.0

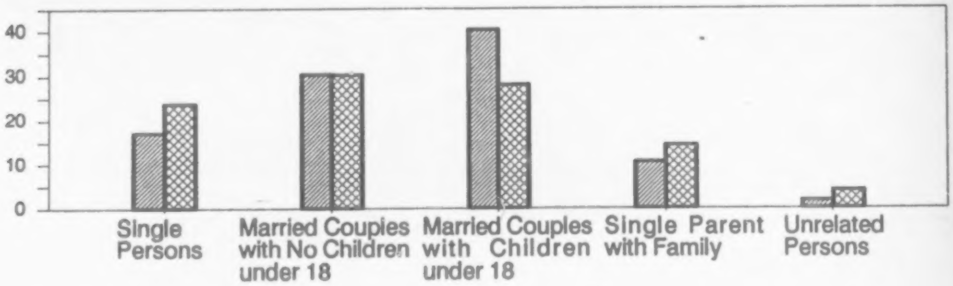
[1] JEC estimate based on Census Bureau data.

[2] JEC estimate based on work of Leon Bouvier and Anthony Agresta, appearing in Asian and Pacific Immigration to the United States.

Source: Census Bureau, except as footnotes explain.

Lower birth rates have led to smaller family sizes for a number of years. Between 1970 and 1987, the average size fell from 3.6 to 3.2 persons. This tend is expected to continue in the next decade as well. The same is true for households in general, which decreased in average size from 3.1 to 2.7 in the same time frame. Household composition has changed noticeably over the past several decades. Chart V.3 traces this development from 1970 to 1985.

Chart V.3
DISTRIBUTION OF HOUSEHOLD COMPOSITION, 1970 & 1985
Percent of all Households



SOURCE: Bureau of Economic Analysis.

Two features stand out. The "Ozzie and Harriet" family—husband and wife with children under 18—became less prominent, declining from 40.3 percent to 27.9 percent of all households. This trend by no means suggests that traditional families are in danger of extinction; it is in part a product of the demographic wave. Second, the rise of single- and unrelated-person households and families with single parents represents larger social changes, from preferences in lifestyle to an increase in divorces. Closer inspection of data indicates that household composition fluctuated more in the 1970s than in the 1980s, indicating that current shares may not show as much change in the next decade.

Trends in education

The general population has shown moderate educational improvement over the past few decades. Overall, the median number of years of school has increased from 9.8 in 1970 to 12.3 in 1986. Most of that improvement occurred in the 1970s and is associated with the baby boom bulge. During the same time, the percentage of college graduates in the population grew from 10.7 percent to 19.4 percent. Among persons aged 25–29, 23.4 percent are now college-educated.

The black population has made welcome progress in educational attainment, particularly those in the 25–29 age bracket. Their median school years rose from 12.1 to 12.7 in the 1970–86 time frame, while the national median remained 12.9. The Hispanic population also showed marked improvement in this age group and time, recording a change from 9.1 to 11.7. College completion rose from 4.4 percent to 10.9 percent of blacks and from 4.5 percent to 8.4 percent of Hispanics in this age group.

The grim side of the educational picture deals with dropouts, a problem that persists despite monumental efforts by government, private groups, and communities. Again concentrating on the 25–29 age cohort, one in seven did not complete high school. Among blacks, one in six dropped out. A comparable figure is not available for Hispanics, but related measurements suggest a dropout incidence even higher than that for blacks.

The economic reality confronting the lower educated population is disheartening. The U.S. economy is evolving into activities that are creating jobs and opportunities in areas requiring high levels of skills and training. Simultaneously, the growth of new lower skill jobs will not keep pace with job growth in higher skill occupations. This discussion continues in a later section of this chapter.

Geographic trends

U.S. society is increasingly urbanized, a trend as long-established as it is likely to continue. Around 1918, the United States first became an urban nation, with more than half of the population residing in communities exceeding 2,500 in size. Today, three-quarters of all persons live in metropolitan areas of 50,000 or more.

In America's two centuries, population growth has never been uniform countrywide. This has held true in recent decades. In fact, the 1970s even recorded a reversal in a longstanding pattern of faster metropolitan growth than nonmetropolitan. However, that circumstance reverted back to its historical trend in the 1980s. Most of the postwar population growth has occurred in the suburban surroundings of larger cities. That trend will continue in the years to come, too.

Not all metropolitan areas are growing. The central cores of many major cities have encountered significant outmigration, resulting even in population decline in many cases. Smaller metropolitan areas, particularly those reliant on agricultural, natural resource, and energy industries, have also suffered population slowdowns or actual declines.

This sectorial observation is noteworthy. The 1980s have shown the population to react relatively quickly to enonomic downturns in industries with a regional concentration. Likewise, the population has responded to opportunities arising in areas experiencing growth, particularly the South and West. This response to changing economic conditions shows a desirable resilience and adaptability in the work force, especially among newer entrants. The likely outcome of this flexibility will be a higher standard of living for individuals and greater and more efficient economic output for the Nation.

Perhaps the most revealing description of population growth disparities is seen at the county level. Of all 3,138 counties, 1,114–35.5 percent—experienced declining populations between 1980 and 1986. The lion's share of these counties are classified nonmetropolitan. The Midwest has a history of counties in decline. That trend continued in the 1980s, along with an addition of a cluster in the interior South. Besides the cluster, all regions of the country have pockets of declining population.

A projection of regional change, 1986–2000

Available population projections do not, and really cannot, estimate exactly how the U.S. population will shift and change as described here. But with some certainty, policymakers can expect trends discussed here to continue. By drawing from two different sources, a regional projection was constructed for purposes of illustration. The population growth of the 50 largest U.S. cities was coupled with Census Bureau estimates on overall population growth.

The results, summarized in Chart V.4, show considerable divergence among the regions.

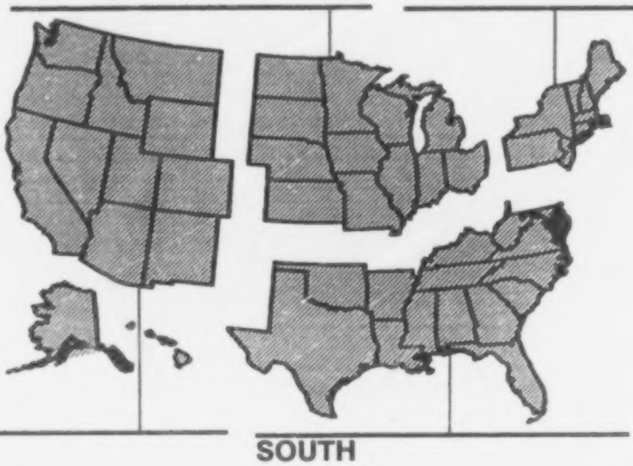
Chart V.4
REGIONAL POPULATION TRENDS, 1986-2000

MIDWEST

Population: +0.3 Million, +0.5%
Congressional Districts: Lose 15

NORTHEAST

Population: +1.8 Million, +3.6%
Congressional Districts: Lose 10



WEST

Population: +10.7 Million, +21.9%
Congressional Districts: Gain 12

SOUTH

Population: +13.9 Million, +16.8%
Congressional Districts: Gain 13

U.S. TOTAL

Population: +26.7 Million, +21.9%
The 50 largest cities nationwide are expected to grow 22.7 million, accounting for 85% of total population growth.
In addition, 92% of total population growth will occur in the West and South.

The population of the Midwest is expected to grow only very slightly (300,000) between 1986 and 2000. Five of the 50 largest cities are located in the Midwest. In this 14-year span, they are expected to grow by 1.3 million—an amount greater than the Midwest overall. Consequently, the remaining areas of the Midwest will decline by a million. The Northeast fares somewhat better, gaining 1.8 million people. But like the Midwest, the nine largest cities account for greater growth than the net increase in population. Those cities will grow by an anticipated 2.4 million, resulting in a population decrease of 0.6 million for the remainder of the Northwest.

In the South, the largest cities account for the majority of growth, but not to the severely offsetting degree cited for the Midwest and Northeast. The South will grow by 13.9 million, and the 20 largest cities will grow by 9.3 million, leaving a population increase of 4.6 million for other areas. The West is expected to have the highest growth rate, 21.9 percent, based on a population increase of 10.7 million. Here, the 16 largest cities will absorb all but 1 million of the total, spread out over a vast land area.

Summary statistics foretell America's growth future: Between 1986 and 2000, an estimated 85 percent of population growth will occur in the 50 largest cities. From a regional perspective, the South and West will account for 92 percent of population growth.

A changing Congress

The House of Representatives after the year 2000 will be far different from today's. If the Census estimates hold true, the South will gain 13 seats, the West 12. Those sets will be forfeited by the Midwest, likely to lose 15, and the Northeast, the remaining 10. As many as 31 seats will shift to fast growing States. Five States are potential big gainers: California (+10), Florida (+6), Texas (+6), Georgia (+3), and Arizona (+3). Among the States apt to lose three or more seats are Illinois, Michigan, Ohio, Pennsylvania, and New York.

After the 2000 decennial census, congressional district borders will be redrawn in most States regardless of changes in representation. Again, population shifts will contribute to the design. As more people reside in suburban settings, more Representatives will serve suburban areas. Urban cores probably will lose a few seats, but most of the transfer will be from rural areas. Rural congressional districts will greatly expand in size in order to meet the population requirements established by the principle of "one man, one vote."

THE ECONOMIC IMPLICATIONS OF DEMOGRAPHIC CHANGE

The myriad changes in the population described here have a direct effect on all aspects of the economy. Elementary economic analysis examines these developments in terms of both supply and demand, and production and consumption. At the core of our free market system are individuals. They are producers at work and consumers at home. They are labor suppliers. Their savings are part of an investment supply. They are demanders of material goods and services.

Over time, the economic behavior of individuals changes. Their tastes and preferences shift—most elderly people do not attend rock concerts, for examples. Besides age factors, household arrangements also affect consumption patterns. As would be normally expected, younger households devote more of their income to the purchase of durable goods than do older households.

According to a Federal Reserve study summarized in Table V.2, housholds headed by persons under age 35 devote twice as much of their total expenditures to durable purchases than do those over age 65. Regarding nondurable purchases, the trend is the same. With advancing age comes a lower proportion of nondurable purchases, but not as sharp a change as with durables. Single-person households undergo a bigger change in these patterns than do other households.

TABLE V.2.—PERCENT DISTRIBUTION OF PERSONAL EXPENDITURES

[By age and size of urban household, 1982–83]

Age	All households			Single-person households		
	Durables	Nondurables	Services	Durables	Nondurables	Services
Under 25	17.7	33.3	49.0	15.6	35.1	49.3
25–34	18.0	30.1	51.8	17.3	30.7	52.0
35–44	16.0	30.9	53.1	15.8	28.6	55.6
45–54	14.8	30.9	54.3	14.5	28.1	57.4
55–64	11.8	30.1	58.1	10.1	28.3	61.6
65–71	8.8	26.2	65.0	6.3	23.0	70.7
All	14.6	30.0	55.3	12.9	28.5	58.6

Note.—Services includes imputed rent on owner-occupied housing.

Source: Federal Reserve analysis of Bureau of Labor Statistics data.

Services comprise the remainder of consumer purchases. By deduction, they account for a growing share of expenditures as households grow older. For all households, services purchases go from about half of the total for the youngest households to almost two-thirds for the elderly; elderly single persons devote an even larger share.

Independent of the impact of a changing population, the U.S. economy is becoming more service-oriented. The previous table suggests the demographic wave will amplify that trend. The advancing age of the baby boom generation implies that durable goods purchase growth will slow and services will accelerate in the next decade. Housing, a "big ticket" item of goods production and consumption, will probably slow down in the years to come. Housing construction will decline because household formations have slowed with progression of the baby boom. In addition, house size likely will be smaller, due to changes in household size and composition.

Just as the wave has an effect on consumption, so too will it affect saving patterns. Personal saving, which was low in the 1980s, is likely to change for the better in the next decade. Household saving patterns vary with age. Newer households just becoming established and starting families naturally spend far more of their disposable income than do couples on the verge of retirement and whose children are fully on their own. Another trend bodes well for saving. Baby boomers are entering a period of their careers marked by income advancement due to more experience on the job. More income makes saving easier.

CHANGE IN THE LABOR FORCE

The demographic wave cuts across the labor force just as it does the whole population. The remainder of this chapter draws heavily on the Bureau of Labor Statistics' Projections 2000, published in the September 1987 issue of the Monthly Labor Review. For summary purposes, the estimates for the 2000 appearing here are based on their intermediate assumptions of economic performance.

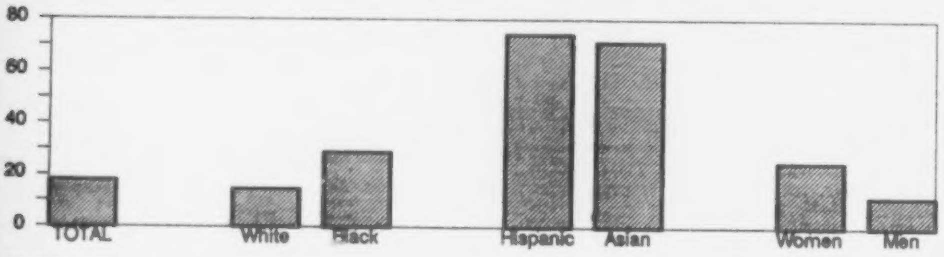
As the total population grows by 27 million between 1986 and 2000, the labor force (basically, persons over 16 who either have a job or want one) will grow by about 21 million, or by 18 percent. Closer examination of the projections reveals some significant changes in the composition of the labor force, with two standout features: Of the increase, women will account for 63 percent; Asians, blacks, and Hispanics will comprise about 57 percent.

Moreover, by the year 2000, the Hudson Institute estimates that only about 15 percent of new labor force entrants will be native-born white males—the group that dominated the labor scene for most of American history. The following chart and table help to show why. Growth rates for other subgroups, notably the 70-plus percent figures for Hispanics and Asians, are far higher than other categories.

Chart V.5

GROWTH RATES FOR SELECTED LABOR FORCE GROUPS

Percent Change, 1986-2000



SOURCE: Bureau of Labor Statistics.

TABLE V.3.—SELECTED LABOR FORCE CHARACTERISTICS, 1986–2000

[Millions of persons]

Group	1986	2000	Change 1986–2000	Percent change 1986-2000	Share of total (percent)	
					1986	2000
Total	117.8	138.8	20.9	17.8	100.0	100.0
White	101.8	116.7	14.9	14.6	86.4	84.1
Black	12.7	16.3	3.7	28.8	10.8	11.8
Hispanic	8.1	14.1	6.0	74.4	6.9	10.2
Asian	3.4	5.7	2.4	71.2	2.8	4.1
Women	52.4	65.6	13.2	25.2	44.5	47.3
Men	65.4	73.1	7.7	11.8	55.5	52.7

Note.—The race/origin subgroups overlap and therefore do not add to total. Percent change column was derived from 3-decimal data.
Source: Bureau of Labor Statistics.

The age distribution of the labor force will also be influenced by the demographic wave. Between 1986 and 2000, the ranks of those in their "prime working age" (ages 25–54) will swell, from 80 million to 101 million. The number of older workers (over 55) will not change much, increasing by 1 million. A decline of 1 million is expected for youth workers aged 16–24 (that net change somewhat masks a decline through the mid-1990s followed by a reversal). This development may signal a slight period of labor shortage in some regions and sectors. The number of 25- to 34-year olds will increase until the mid-1990s, and then show a steep decline. The opposite will occur with the 55–64 age group, whose numbers will decline and then increase rapidly.

The job wave operates independently of the demographic wave, and it too will have an important impact on America's future. Workers' response to it could largely determine our economic growth or decline. The wave is generated by technological innovation, which is radically altering what we do and how we do it. The job wave promises the opportunity of higher incomes, greater output and improved productivity, but at a certain price: In order to harness the benefits of technology, workers of the future will need to be better educated and trained, and more highly skilled, resourceful, and adaptable.

In the next decade, just as in the past several, not all industries will be keeping pace with overall economic growth. The uneven growth of various sectors shows an adaptive free market system responding to society's desires and capabilities. Employment trends in industries do not necessarily coincide with changes in output. Technical advance and its productivity gains explain why.

Industrial employment prospects

Projections by the Bureau of Labor Statistics indicate services will continue to be the leading growth sector and will account for most of the net increase in employment. In other industries, strong productivity growth will account for most output growth, especially in agriculture and manufacturing, even if employment slows or declines. Table V.4 tracks projected employment trends by industry.

TABLE V.4.—EMPLOYMENT BY INDUSTRY, 1986–2000

[In millions]

Industry	1986	2000	Change 1986–2000	Percent change 1986–2000
Agriculture	3.3	2.9	−0.3	−10.3
Mining	.8	.7	−.1	−7.5
Construction	4.9	5.8	.9	18.1
Manufacturing	19.0	18.2	−.8	−4.4
Transportation [1]	5.2	5.7	.5	9.1
Wholesale trade	5.7	7.3	1.5	26.7
Retail trade	17.8	22.7	4.9	27.2
FIRE [2]	6.3	7.9	1.6	25.7
Services	22.5	32.5	10.0	44.4
Government	16.7	18.3	1.6	9.7
All industries	111.6	133.0	21.4	19.2

[1] Transportation and public utilities.

[2] Finance, insurance and real estate.

Note.—Columns do not add due to rounding and minor omissions. Percent change column was derived from 3-decimal data.

Source: Bureau of Labor Statistics.

The decline in agriculture occurs largely among the self-employed; wage and salary employment in agriculture offsets that decline to some degree. Goods-producing industries (mining, construction, and manufacturing) will see little employment growth at best. However, several manufacturing industries will prosper, such as printing and publishing, pharmaceuticals, computers, plastics, and instruments. Overall, the growth discrepancies among industries reflects trends in place for some time.

Occupational employment prospects

One glaring fact leaps from the occupational projections shown in the next table: Most of the employment growth occurs in areas requiring relatively more education, skills, and training. Underscoring this development is the technician group, the growth leader at 38 percent for the 1986–2000 period. While not the largest occupational category, it illustrates the trend toward more skill-demanding work. Two other groups requiring higher skills, executive and professional, will each grow by nearly 30 percent, creating over 6 million jobs.

The service and sales categories, which are about average in terms of level of skill required, are expected to grow by over 5 and 4 million, respectively. Three groups offer below-average growth in employment—precision production, craft, and repair; administrative support; and operators, fabricators, and laborers. Two are expected to experience declines in employment, namely agriculture and private household workers.

TABLE V.5.—EMPLOYMENT BY OCCUPATION, 1986–2000

[In millions]

Major occupational group	1986	2000	Change 1986–2000	Percent change 1986–2000
Executive, administrative, managerial	10.6	13.6	3.0	28.7
Professional workers	13.5	17.2	3.7	27.0
Technicians and related	3.7	5.2	1.4	38.2
Salesworkers	12.6	16.3	3.7	29.6
Administrative support [1]	19.9	22.1	2.3	11.4
Private household workers	1.0	1.0	0	−2.7
Service workers	16.6	22.0	5.4	32.7
Precision production, craft, repair	13.9	15.6	1.6	12.0
Operators, fabricators [2]	16.3	16.7	.4	2.6
Farming, forestry, fishing	3.6	3.4	.2	−4.6
All groups	111.6	133.0	21.4	19.2

[1] Includes clerical.

[2] Includes laborers.

Note.—Numbers do not necessarily add due to rounding. Percent change column was derived from 3-decimal data.

Source: Bureau of Labor Statistics.

Because of the skills demanded by faster growing occupations, some policymakers have sounded alarms about a growing mismatch between workers' abilities and job requirements. Labor experts share their concerns but generally do not consider the problem to be of catastrophic proportions. Projections show a higher than average growth rate in jobs requiring one or more years of college, causing the share of higher education jobs to rise in the coming years. The share for high school level jobs will likely fall.

The major area of concern lies with the work force possessing less than a high school level of ability. A sharper decline in employment opportunity is expected for lower educated persons. In the labor force, one in seven workers does not have a high school diploma. Those currently with jobs will need to obtain greater skills and training to hold onto them. Those without will find job attainment and satisfaction more difficult.

Further analysis shows that occupational groups with a higher predominance of blacks and Hispanics have lower growth rates than other job groups. The same is true but to a lesser degree for women. The response to this situation is not to preserve these obsolete jobs, but rather to elevate skills of those affected.

PUBLIC POLICY RAMIFICATIONS

The demographic and economic trends protrayed here are very likely to continue. To prepare for them, the policymaking challenge is to augment our free market system's response to change.

The market economy remains the proven maximizer of well-being for a society. History has demonstrated time and again that alternatives, which rely on centralized control or on the usurped autonomy of individuals, ultimately have fallen short of the performance of the market. Our free market system operates with signals—prices, profits, surpluses, and shortages, to name a few—and individuals respond and adapt to them. As conditions change, these signals change, and individuals react accordingly. Individuals know what is best for themselves, their communities, and their country. The future portends great changes for our economy, requiring flexibility and modification on the part of individuals and institutions alike.

What can the public sector do to augment the market system's response to change? First and foremost, policymakers should ensure that Federal action provides incentives for achievement, instills self-reliance, fosters enterprise, and rewards accomplishment. Conversely, government should avoid action that impedes ambition or produces dependency.

Along this line of thought, government can and should motivate and encourage the public to excel. Adam Smith's "invisible hand" of self-interest is not self-ish, as some critics suggest. The pursuit of mutual self-interest embodies the attributes of cooperation and support, so that all members benefit from the gains of their efforts.

Beyond these tenets of the free market system, demographic changes in our future requires an examination of fiscal undertakings. The allocation of public resources must be based on the dictates of changing needs and goals. Demographic considerations should influence budgetary considerations. For example, a shifting and growing population requires steadfast planning for highways, transportation, and other infrastructure.

The human resources dimension in the high-tech, information-age, service economy is of paramount importance. To prepare for the future, individuals need more education, training, and job skills to cope with a rapidly changing workplace. The private sector recognizes what is at stake here, and many firms have addressed this issue with innovative training programs to enhance skills and productivity of workers. This trend will be growing in the future.

The 1990s present a kind of test of will for U.S. society. While demographic change represents challenge and adjustment, the near future is a cakewalk compared to the decades to follow, when the baby boom retires and becomes either an economic asset or liability.

Baby boomers are now in the mainstream of the economy. They both have benefited greatly from and are partly responsible for a record-breaking economic expansion, now in its seventh year. The economic and social success of the next decade and beyond rests squarely on their shoulders. Their economic judgments, decisions, and planning—in their personal lives and careers alike—weigh heavily on prospects for the next century.

There is a global significance to the next decade as well. Independent of U.S. economic developments, other major industrial nations will be marching forward with an ambitious and trained workforce, armed with both determination and state-of-the-art technology. If the U.S. economy falters, others are ready, willing, and able to put us at a competitive disadvantage.

Robert C. Holland, President of the Committee for Economic Development, refered to the next 20 years as a "window of opportunity" for America at an economic conference at the Hoover Institution in November 1988. In his address, he stated:

> If these baby boomers eagerly and productively employ their talents and save and invest prudently for their old age, and if the rest of us give them an environment that encourages them to do so, then the United States could undergo a period of economic strengthening and growth that would create prosperity at home and a new era of U.S. leadership in the family of nations.

Resisting change is not a desirable economic policy alternative. Our brightest future is one that embraces change and the opportunities and advancement it offers.

VI. Conclusion

As Republican Members of the Joint Economic Committee have stated on countless occasions, change—with its accompanying challenges and opportunities—is intrinsic to our economic system. We have a fundamental confidence in our market-oriented, incentive-based form of democratic capitalism. We continue to strongly caution against knee-jerk government policy and program interference in reaction to perceived "vulnerabilities."

For six and one-half years, we have watched and listened to this economy respond to market-supportive economic policy and thereby make moot the calls for massive make-work jobs programs, tax increases, more regulation, and protectionism. The economy is teaching; hopefully the Congress is learning.

ADDITIONAL VIEWS OF REPRESENTATIVE OLYMPIA J. SNOWE

While I am in general agreement with much of this year's Minority Views of the 1989 Joint Economic Report, I have chosen to file some Additional Views on a few topics. Furthermore, I have some thoughts and comments about the section on international trade issues that require further elaboration.

As I said in the 1988 Report, I would simply reserve final judgment on giving the President line-item veto authority, without necessarily dissenting from this year's Minority Views. In the past, I have voiced concern about how such authority could upset the balance of power between the Executive and Legislative Branches of our Federal Government during the annual budget process.

This year's Minority Views call for the elimination of the practice of using the "current services" baseline concept. This assumes that certain spending in Federal programs will grow by a sufficient amount to ensure that the same level of government service is provided annually, absent any change in these programs.

While I recognize that President Bush's budget submission does not use the "current services" baseline, I am not convinced that it should be eliminated outright, as called for by the Minority Views. This is an issue that the 101st Congress should analyze closely before eliminating the budget baseline method used most frequently in recent years.

As in the 1988 Republican section, this year's Minority Views also contain a brief discussion of the 1981 tax bill. And as I said last year, that legislation was an important first step in the overall process of reforming our tax laws. The Economic Recovery Tax Act laid the groundwork for the movement that culminated in the comprehensive tax reform legislation enacted in 1986. I continue to believe that the Congress should monitor closely the final implementation of this multiyear measure and its impact on low- and middle-income taxpayers.

I also wish to respond to several issues raised in the international trade section of the Minority Views, including reported progress with the merchandise trade deficit, U.S. objectives in bilateral and multilateral agreements, and the meaning and implications for the economy of foreign investment.

The Minority Views ascribe to U.S. exports much of the improvement in the trade deficit during 1988. In fact, the merchandise trade deficit dropped from $152 billion in 1987 to $118 billion in 1988, a 20 percent reduction. However, the prospect for further improvement at this rate is murky, as demonstrated by the Department of Commerce's figures for November and December of last year.

During November, the trade deficit grew by 25 percent to $11 billion, the highest mark since last June. Imports reached a level of

$38 billion, raising additional concerns about the inability of Americans to consume less and save more. Moreover, the monthly trade figure in December reached $11.9 billion. U.S. purchases of foreign and industrial business equipment expanded, and the heavy cost of imported oil made headlines and has once again become a visible problem for the economy.

For 1989, assuming our goal in the United States is to maintain reasonable economic growth, we face a difficult challenge in keeping the rate of export growth ahead of import growth, thus narrowing the trade deficit. Indeed, our trade deficit with Japan lowered by 9 percent in 1988, to $47.5 billion, due to some marginal improvements in market access and domestic consumption. However, evidence suggests scant likelihood that our trade deficit with Japan will soon disappear.

Our preoccupation with Japanese trade cannot obscure our equally important trade relationship with Europe. There, the specter of a united market in 1992 does not bode well for expanding our market opportunities and exports. Maintaining access for U.S. firms and products, already a problem, could deteriorate further. We must work domestically and with the European Community to ensure that 1992 does not produce a protectionist Fortress Europe.

The United States must continue to exert its leadership in the international economy, insisting on free and fair trade and equal market access. Without improvements in exports, and absent progress to eliminate the Federal budget deficit, I suspect the trade imbalance could become a negative, debilitating fixture. Restoring the United States to a balanced position in global trade must remain a priority.

The Minority Views also emphasize that the United States should continue to emphasize free trade principles and discourage protectionism by other nations. This is fine, so long as we are realistic.

In her February 1989 testimony to Congress after being nominated for the position of United States Trade Representative, Carla Hills outlined four U.S. trade objectives: a successful completion of the Uruguay Round GATT negotiations; the protection of U.S. interests in our economic ties to the European markets; implementation of bilateral agreements reached with Canada and Israel and pursuit of new such bilateral agreements; and improvements in market access to Japan and the NIC nations of the Pacific Rim.

I agree with Ambassador Hills on framing U.S. trade strategies around these objectives, but I worry that international trade rules and procedures are becoming irrelevant in an increasingly internationalized economy.

It has been reported that GATT rules and principles now cover less than 7 percent of global commerce and financial flows. In addition, as economist Pat Choate pointed out (Harvard Business Review, Jan./Feb., 1988), nearly 75 percent of all world commerce is conducted by economic systems operating with principles at odds with those of the United States.

We need to ask what steps can be taken to address the other 93 percent of global commerce not covered by GATT, and how U.S. policies respond to the differing economic systems of other countries to expand international opportunities for U.S. businesses?

The United States must continue to espouse the virtues of improving the international economy by eliminating foreign trade barriers and furthering market access. However, we cannot afford to maintain the outdated assumptions that the old trade rules still apply and that other nations will be quick to reverse their current policies and come around to our way of thinking.

Lastly, I remain apprehensive about the levels of foreign investment in the United States, including our dependence on foreign capital to fuel the Federal budget deficit, and growth in foreign ownership of U.S. property, including land, capital, and businesses. While we may understand the economic reasons why foreign investments are expanding so rapidly, and the need for foreign capital to meet Federal Government borrowing needs, I doubt we as a nation understand fully the implications and long-term ramifications of foreign ownership.

I believe all leading industrial nations must learn, comprehensively, how their economy functions within the framework of an international flow of capital goods and services. Other nations have long since taken basic steps to monitor foreign investment levels to ascertain what drives national economies and how capital is being utilized. The United States, however, lacks this information, which further hinders our ability to develop a sensible, long-range trade strategy.

Foreign ownership of U.S. businesses and real estate is less than 5 percent of our total assets, but the growth in ownership has climbed dramatically in recent years following favorable U.S. economic trends attracting outside investments. As of 1987, foreign-held assets totalled $1.5 trillion. In addition, over 45 percent of patents granted by the United States in 1987 went to foreign interests. One-third of total foreign investments in the United States has taken place in the last three years. Moreover, while U.S. business investments abroad have grown by 60 percent since 1979, the growth rate of foreign investments in this country has climbed 350 percent.

The United States has no direct experience with this level of foreign investment, and I fear that we are not prepared to address its long-term implications. Americans rightly worry about this, and they properly ask about its impact for the U.S. economy, for jobs, and for our way of life.

OLYMPIA SNOWE.

○